

CHAPTER 8

The Informal Sector and the State: Institutions, Inequality, and Social Norms

SUMMARY: This chapter argues that the state–society interactions underlying informality, whether leading to exclusion or to exit, ultimately constitute an indictment of the overall effectiveness and legitimacy of the state. As noted before, burdensome business and labor market regulations, poorly designed social protection systems, and weak enforcement capabilities bias the cost–benefit assessments of firms and workers in favor of informality. Furthermore, a collective perception of ineffectiveness, unfairness, and illegitimacy of the state’s actions, in terms of who it represents and serves, can give rise to a social norm of noncompliance with taxes and regulations (a “culture of informality”), which further undermines the state’s capacity to enforce the law and to provide effective public services. This is partly related to the inability of the state to redress the long-standing high inequality in the region, resolve social tensions, and uphold the rule of law; and it crystallizes in a dysfunctional underlying “social contract.” In Hirschman’s terms, it is a lack of voice and loyalty. Thus, addressing informality in Latin America requires bolstering the competency and legitimacy of the state by delivering the correct set of “carrots” in more equitable public policies and programs to foster a sense of greater inclusion and responsiveness, while carefully considering the incentives created to become formal or informal, and by wielding adequate “sticks” through political resolve and evenhanded enforcement of laws and regulations.

THIS REPORT HAS VIEWED INFORMALITY through the lens of the relationship between economic agents and the state. Several chapters have discussed how specific policies in the areas of labor legislation, business regulation, social protection, and taxation can have a critical impact on microlevel decisions that foster or preclude agents’ participation in the formal economy. These policies define a comprehensive set of incentives to which individuals and firms respond by weighing the costs and benefits of participating in different markets and the enforcement efforts and capabilities of the state. This chapter argues that these economic responses are also influenced by how agents—individually and collectively—perceive and define a relationship with the state. In some situations, there are “social norms” that are influenced by the perception of the effectiveness of the state and the collective projects it represents, and that foster willingness to comply with taxes and

other regulations. For instance, the high tax compliance rates observed in developed countries cannot be explained only by the deterrent effect of the chance of being caught evading and the ensuing penalties.

In Latin American economies, with large informal sectors, the individual cost–benefit analysis leading to *exit* from taxation and other regulations, and from participating in the formal circuit of taxes and transfers, in the Hirschmanian sense, may be influenced by a collective perception that the state’s action is ineffective, inefficient, and unfair. In a social exchange view, willingness to comply with regulations may be affected by the individual perception of the effectiveness of the government in providing services. Moreover, a collective perception—the “sentiment” within a group—about the performance of the state influences the social norm regarding compliance. For instance, if more people operate in the informal sector, it might be easier for each citizen to do so; for a given level of state enforcement

effort, one person will be less likely to be sanctioned if lots of people also evade taxes or do not comply with other regulations; the psychological/ethical costs of evading will be lower if most people in one's peer group do so, and hence one's tax morale and disposition to comply with regulations will be lower. This interdependent behavior might generate a social multiplier that might make a specific social norm more prevalent. This type of mechanism might be behind what has been dubbed a "culture of informality" that prevails in many Latin American countries.

Informality is also a reflection of mechanisms that *exclude* large segments of the citizenry from education, health care, and judiciary services; and from economic opportunities through a segmented labor market and imperfection in other factor markets. This exclusionary process is related to the extremely high and persistent levels of inequality, which are rooted in differences in power, voice, and influence; and which, as reported here, seem empirically highly correlated with informality.

Latin America's low level of trust in the state, its culture of informality, and often the design of its regulations and policies reflect what we might call a "dysfunctional social contract" under which the state is not complying with its designated roles and individuals therefore see little point in playing by its rules. We use the expression *social contract* to refer to some degree of societal consensus over basic aspects of the operation and role of the state relative to the private sector and among citizens. In this usage, *social contract* refers to key aspects of a social equilibrium, including beliefs and actions of citizens, organized groups, and state actors. Among the aspects that enable us to characterize this contract are the structure of taxation and social expenditures (Lledo, Schneider, and Moore 2004), the performance of the state in using citizen's taxes in delivering public goods, and the structure and effectiveness of the social protection systems (Birdsall and Menezes 2005; ECLAC 2006).

Heuristically, this situation may be characterized by a "bad equilibrium" where certain norms are being upheld, implicitly or explicitly. The state might be ineffective, able neither to enforce well its regulations—the sticks—nor to lure firms and individuals to formality by providing quality public goods and services for all—the carrots.

Many Latin American countries seem to be in a situation where the share of informality is high; trust in the state is low; tax morale and regulatory compliance are low and, hence, enforcement of regulations and tax collection are generally low; and public provision of public services is

inequitable and of low quality. Firms, workers, and citizens in general make decisions based on the state's enforcement capacity and on their perceptions about the effectiveness of the state and of prevalent social norms. These decisions, in turn, affect the capacity of the state to enforce regulations and provide high-quality public goods and services for all.

Alternatively, an economy may be in a "good equilibrium" where a large mass of the economy operates formally and public goods and services are provided effectively and where the government is able to enforce the agreed regulations and taxes—which, in turn, is facilitated by a social norm that induces people to comply. Even if economies are, in general, not "stuck" in any of these equilibria, in many cases they have features that resemble these feedback loops that might impede the reduction of informality.

Throughout this report we have described many features that relate to different measures or dimensions of informality and that, indeed, are reflections of a systemic failure. Among those features, we have

- low levels of participation in the social security system
- low coverage of many social insurance schemes, especially among poor people
- a large number of small firms (and larger ones) that partially or completely evade tax, labor, and business regulations
- low-quality regulation that increases red tape
- exclusion in the access to property rights, judiciary services, and other public services
- low-quality public provision of many social services (such as health care or education)
- low levels of trust in the state and in the fairness of dominant arrangements
- low and uneven enforcement
- with exceptions, low levels of tax collection, related to low compliance and low tax bases.

Each of those features is, in itself, a reflection of a dysfunctional individual and collective interaction with the state, intimately linked with the state's inability to perform effectively and equitably its main roles—roles of remedying market failures, coordinating the provision of public goods, and maintaining a level and equitable playing field. Seen from a less state-centered perspective, the features mentioned above may also be a reflection of dysfunctional social equilibrium in the "horizontal" relationships among citizens—how they interact with and the degree to which

they trust each other. In other words, several of the phenomena that may be related to the notion of informality are, in the end, a reflection of the way individuals interact both with the state and with each other.

In this chapter, we explore several characteristics of the social contracts that prevail in the different countries of the region. This chapter also will present suggestive evidence of the kind of feedback loops mentioned above. We dwell on the different manifestations of informality that concern the relationship between the individual and the state, emphasizing how social norms and social interactions also might affect the decision maker. We discuss and present some evidence related to perception and performance of the state and how they correlate with informality. The chapter then focuses on the roles of taxes and how tax compliance is related to the real and perceived role and effectiveness of the state. We also discuss the structure of taxes and transfers and its relation to inequality and informality, as well as other elements that illustrate the exit or opting-out mechanisms that are observed in the region.

Social norms, the state, and informality

Latin America's high level of informality is a manifestation of disconnects between the state and citizens, in part as a result of failures of the state in its various roles. Here we present some evidence of firms' and individuals' perceptions of the performance of the state, and how these perceptions correlate with indicators of informality. To frame the analysis of these correlates, we provide first a framework to discuss different dimensions of the decision to participate in the formal economy.

Dealing—or not—with the state

Throughout the report, we have stressed the cost–benefit analysis that individuals undertake in deciding what sector to work in, whether to register their firm, and whether to pay their taxes or risk detection and punishment. In this section, we further explore how individual perceptions about the performance of the state and how social norms and social interactions might also impinge on these decisions to opt in or out.¹ Consider the case of a worker or a microentrepreneur who has two employment/business opportunities that are somewhat comparable in some other dimensions (such as net earnings), but that differ in the fact that one is formal and requires complying with all regulations, and the other is informal. From the individual point of view, the occupational choice entails having a position

simultaneously in several realms. As an illustration, consider this nontaxonomic list:

1. obtaining the protection of labor laws, paying contributions, and getting social security benefits for the worker and his or her family
2. avoiding the costs of being caught not complying with regulations, given state enforcement technology
3. contributing to the provision of public goods and services to society as a whole, and trusting the state in doing it
4. avoiding the peer-pressure cost of being singled out as a cheater.

To assess costs and benefits, the worker will take into consideration a number of factors that have the state as the main actor. Among others, the informality decision might be affected by the following:

- *The direct costs and benefits of formality:* The assessment of point (1), above, depends on the costs of labor market regulations and a comparison of those costs with the valuation of the benefits provided to the individual (for example, comparing payroll tax payments with health benefits received, as discussed in chapter 7). Note, however, that what the government can provide depends on its fiscal capabilities, which, in turn, depend on the decisions of agents whether to be formal (and pay taxes and contributions). Massive opting out may generate a negative feedback loop that might move the country to a bad equilibrium.
- *State enforcement capacity:* The assessment of point (2) will depend on the perceived capacity of the state to enforce labor, tax, and other regulations. This is a function of the enforcement technology used and the perceived probability of being caught. This is influenced by individual risk aversion and by the collective perception of this probability. In addition, however, the formation of these collective perceptions may be influenced by social multipliers. Another negative feedback loop is possible here because low enforcement capacity implies fewer resources for the state.
- *Individual perceptions about government effectiveness:* The assessment of point (3), above, might depend on how effective and fair the individual perceives government institutions to be in fulfilling its role. The individual might not be amoral and might decide to comply

with regulations not only as a result of the cost–benefit analysis of a utility maximizer, but might also be factoring in the degree of citizen/taxpayer satisfaction with, confidence in, and trust in government. A perception of state incompetence, unfairness, and corruption may affect willingness to comply. The literature finds that, in collective action settings, individuals adopt not a purely materialistic, calculating posture, but a more complex, emotional, and *reciprocal* stand.²

- *Social norms and the social multiplier*: The assessment of point (4) depends on what others believe about the role and performance of the state, that is, the social norm—the pattern of behavior that constitutes a customary rule that coordinates actions among people (Young 2006) and is sustained by social approval—that influences collective behavior toward the state. Deterrence is not enough to explain the observed levels of tax and regulatory compliance, and at least parts of those levels are explained by social interactions. Moreover, if one’s own behavior changes not only because of the influence of an exogenous determinant but also because of the change in the behavior of a reference group, the result is a social multiplier.

The revision of these dimensions of the formality decision illustrates that informality connects to issues pertaining to the reality of and perception about the state. The answer to each of the questions above depends on some characteristics and capabilities of the state and the services it provides, which affect the assessment of the private benefit of engaging with the state. But it also depends on a system of individual and collective beliefs about the effectiveness and fairness of the existing arrangements.

Informality and performance and perceptions about the state

Many Latin American states share the characteristics of what can be called an *exclusionary* state, in itself another manifestation of an imperfect social contract. It is a contract as long as it is an implicit arrangement through which the society has given the state some of the roles mentioned above.

However, in Latin America this contract is failing to define social and economic arrangements that are inclusive and that provide fair rights and responsibilities to all. This generates a perception that the state is not complying fully with its role in the social contract. Manifestation of this is a political equilibrium where certain groups are exempted

from paying directly through taxes, in part because it is too costly for the state to go after them. At the same time, however, they are excluded from the benefits of being protected by the systems regulated by the state or are excluded from receiving public services. Among many others, an example of this exclusion is the inadequate access that the poor have to the judiciary. If, for instance, individuals do not perceive that property rights will be enforced, communities will maintain traditional mechanisms to enforce property rights.³ Another example of exclusion is the existence of large segments of the population that are not covered by any social protection mechanism, the so-called truncated welfare state discussed in chapter 7. And, in a most extreme case of informality generated by an exclusionary process, large segments of the country, often in rural areas, have never been reached by the state. A serious manifestation of this is the problem of unregistered births and undocumented citizens which is still significant in several countries, as the evidence available for Bolivia, Brazil, the Dominican Republic, Nicaragua, and Peru demonstrates (see box 8.1).

A perception that there is an *incompetent state* due to corruption or ineffective governance generates low trust in the state. In addition to directly reducing the benefits of engaging in formal interactions, this might reduce the willingness to comply voluntarily with regulations. Investment climate survey data concerning the efficiency of governments to deliver services show that Latin America appears to fare particularly poorly,⁴ featuring the lowest proportions of firms being satisfied with the efficiency of government services (panel [a] of figure 8.1). Across countries, there is a negative relationship between a proxy of informality and governments’ effectiveness (even after controlling for the level of development). Panel (b) of figure 8.1 shows significant negative correlation between a proxy for government effectiveness⁵ and a proxy for informality. Informality also tends to be higher in countries that are perceived as more corrupt (figure 8.2). As discussed in chapter 6, data for five Latin American countries suggest that the perception of corruption is positively and significantly related to informality.⁶ Companies reporting that bribing government officials to “get things done” is a common practice in their line of business exhibit higher rates of revenue and worker underreporting (see table 6.1). This could be interpreted as firms hiding some of their activities from corrupt officials. But a complementary explanation is that firms that view the government as corrupt are less

BOX 8.1

The extreme of informality and exclusion: Being undocumented

A significant share of the population in several Latin American countries lacks official identity cards, and in this sense is largely invisible to the state. This is an extreme of the continuum of informality by which groups of individuals are absent from the formal circuits of the economy and any interaction with the state. Lack of documentation can have serious consequences, such as making an individual vulnerable to exploitation by employers because of the inability to seek legal redress, preventing access to basic public services and transfer programs, and curtailing the accumulation of human capital through public education. Due to the nature of the phenomenon, regional estimates of the magnitude of this population are hard to come by. However, some representative statistics are available. The Inter-American Development Bank (IDB 2006) reports that demographic and health surveys conducted in Nicaragua in 2001 showed that 17 percent of people over 15 years of age did not have a national identity (ID) card. In the Dominican Republic, a 2004 living conditions survey estimated that about one-fourth of the poorest segment of the population lack birth certificates and identity cards. A survey for a planned project in Argentina indicates that 14 percent of potential beneficiaries lacked national ID cards in one municipality and 17 percent in another municipality. The UK Department for International Development found that, in 2002, between 750,000 and 2 million Bolivian citizens were “functionally undocumented.” Furthermore, it was found that, in some areas of Bolivia, 90 percent of the population lacked a valid form of identification, and the majority was not included in the civil registry at all.

Undocumented adults were, in most cases, once undocumented children who have continued living in a state of official nonexistence. Statistics for birth registrations are more readily available in the region, Duryea, Olgiati, and Stone (2006) find that the lack of birth registration varies from 8.4 percent in Peru to 25.8 percent in the Dominican Republic. They also find that birth underregistration rates are much higher in rural areas than urban areas. In Peru and Bolivia, rural rates are between 25 and 40 percent higher than in urban areas; however, in Nicaragua, rural rates were 200 percent higher than urban rates. Furthermore, the highest birth underregistration rates in Nicaragua are found in areas suffering extreme poverty,

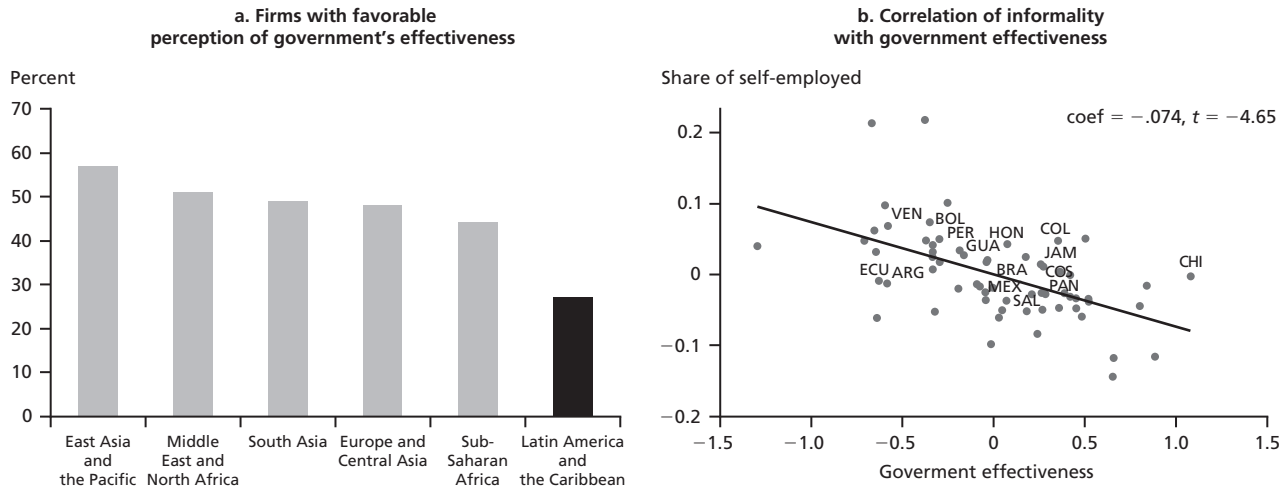
an indication that a key reason for the high rates is the prohibitive cost of traveling to an urban center where there is a government office. Other reasons that are often suggested are a lack of knowledge of the importance of birth certificates and the legal quagmires surrounding registration (for example, if parents are undocumented, it may be very difficult or impossible to register a child).

The effects of not being registered are serious. Using household surveys, Duryea, Olgiati, and Stone (2006) found that for the nearly 300,000 children between 7 and 9 years old who did not matriculate in Brazil, the main reason cited for not enrolling was the lack of documentation. Econometric analysis for the Dominican Republic found that lack of documentation was one of the strongest predictors of school enrollment in higher grades. The International Program on the Elimination of Child Labor—International Labour Organization found that 50 percent of children living in Velleda Morales, a largely indigenous community in Honduras, did not attend school because they lacked a birth certificate. The inability to increase one’s human capital through education has long-term consequences on earnings potential. In contrast, the Inter-American Development Bank (IDB 2006) reports that access to health care services for nondocumented people is much easier in most Latin American countries than access to education—with the exception of Colombia where health services require two forms of identification.

Countries in the region have responded to the registration crisis by combining social targeting programs and registration initiatives. The Inter-American Development Bank (IDB 2006) presents a number of examples, such as Chile where registration has become a part of the nationwide Chile Solidario program that offers, among other things, health care services, counseling, and education services to poor families. Similarly, the Brazilian government has introduced special boats that offer a multitude of services to isolated populations living deep in the Amazon region, including medical services, birth registration, civil marriage, voter registration, and military conscription. Similar initiatives are being developed in the Dominican Republic. Despite these initiatives, additional government efforts and innovations are needed to include these invisible segments of the population in the mainstream of the economy and the social contract.

FIGURE 8.1

Informality and government effectiveness

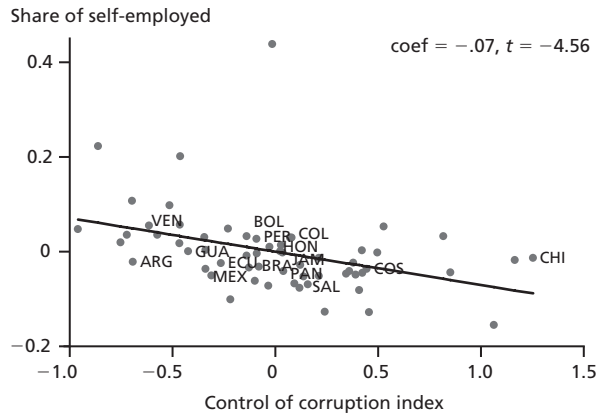


Source: Author's estimates, based on World Bank *World Development Indicators* and *Worldwide Governance Indicators*, (2005); and investment climate surveys.

Note: Figure b shows partial correlations controlling for gross domestic product (GDP) per capita at purchasing power parity (PPP). Government Effectiveness Index measures the quality of public service provision, the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies. Higher values correspond to a more effective government. Firms' perception of government effectiveness is defined as the proportion of firms that report that their government is efficient in delivering services.

FIGURE 8.2

Informality and corruption

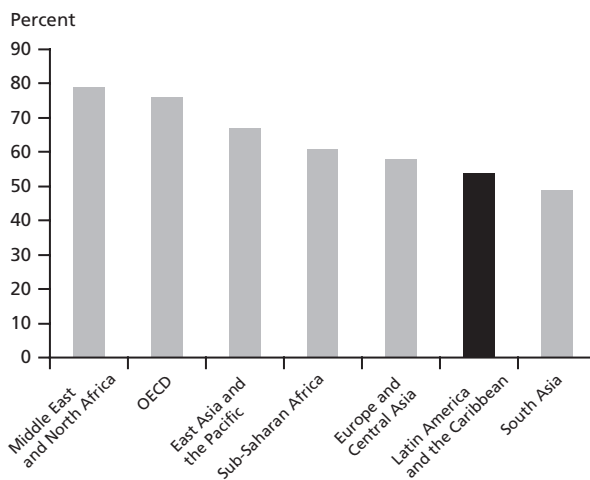


Source: Author's estimates, based on World Bank *World Development Indicators* and *Worldwide Governance Indicators*, (2005).

Note: Figure shows partial correlations controlling for GDP per capita at PPP. The control of corruption index is a measure of perceptions, where corruption is defined as the exercise of public power for private gain, with higher values corresponding to less perception of corruption.

FIGURE 8.3

Share of firms confident that the judiciary will enforce contractual and property rights



Source: Investment climate surveys, (2005), as reported in World Bank (2007).

willing to pay taxes and finance the state. As will be discussed later, this unwillingness relates to the discussion of the so-called tax morale.

Many judicial systems in Latin America are perceived as incompetent, inefficient, and unfair; and this perception

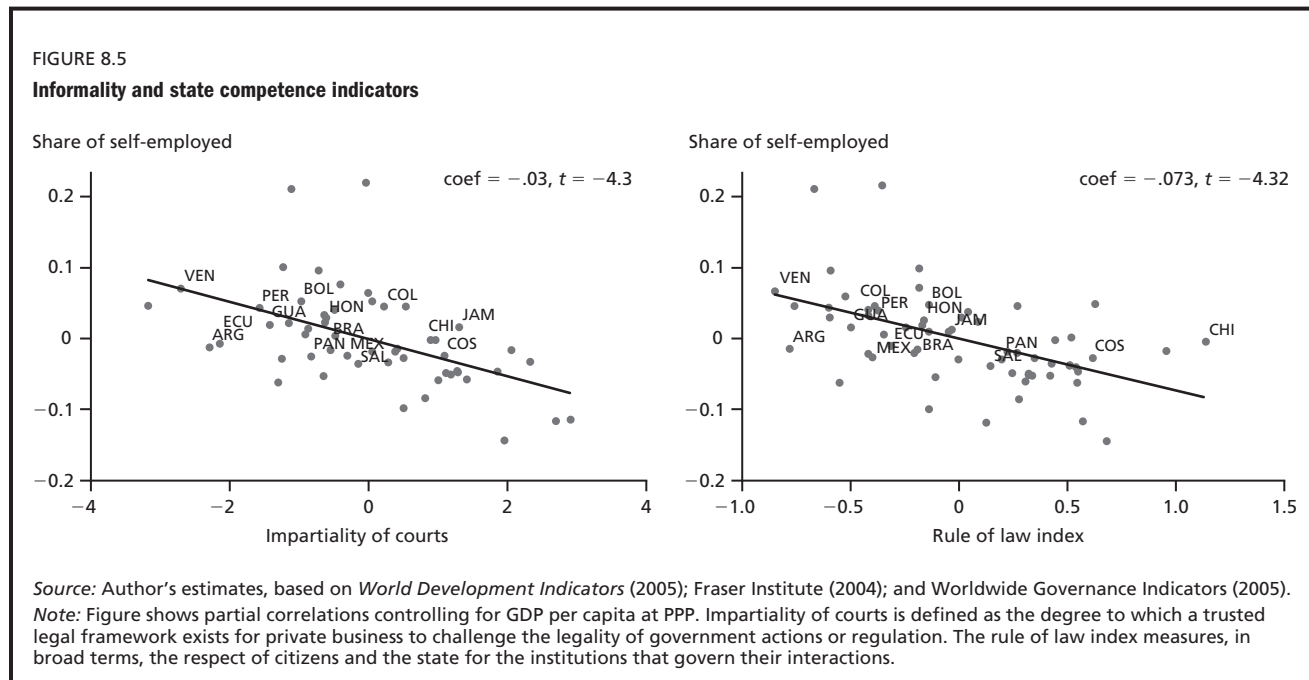
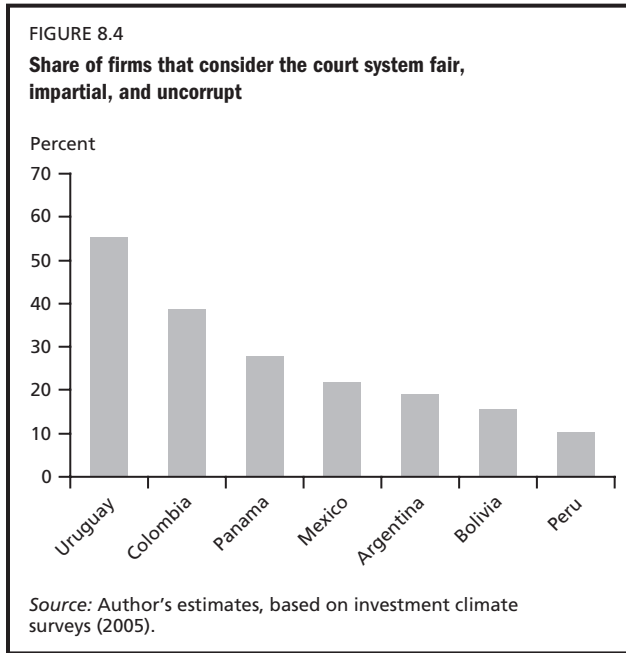
generates very low levels of trust in the judiciary. On average, firms in Latin America are less confident that their judicial system will enforce contractual and property rights disputes than are firms in other regions of the world (figure 8.3). Within the region, there are large differences,

with more than 70 percent of firms being confident in the judicial system in Chile and Costa Rica compared with less than 30 percent in Ecuador and Guatemala. Evidence presented by Biebesheimer and Payne, (2001) shows that although 65 percent of citizens were reasonably confident in their judicial systems in Europe, only 35 percent expressed such confidence in Latin America. In questions asked in recent investment climate surveys, which included a larger sample of small firms, the percentage of firms that perceived courts as fair, impartial, and uncorrupt was less than 25 percent in Panama, Mexico, Argentina, Bolivia, and Peru (figure 8.4).

As discussed by Ronconi (2006), there is ample evidence that people do not trust the judiciary, in part because judges are perceived as corrupt and as benefiting the wealthier side in a lawsuit (Eyzaguirre 1996). Although systematic evidence is lacking, he argues that it is plausible that low levels of trust in the system translate into fewer employees whose labor rights might have been violated bringing their cases to courts because those employees have low expectations of success or because they perceive that they will lack the financial resources to pay for their defense—a perception that often is justified. This perception reduces the probability that employers will be fined and, hence, induces a social norm of noncompliance.

As observed in figure 8.5, impartiality of courts, which the previous figures show is perceived as low in a sample of

Latin American countries, is clearly negatively correlated with informality, even after controlling for GDP. More generally, an indicator of the rule of law from the WGI database, which reflects perceptions of enforcement capacity, of the efficiency of the police and judicial systems, as well as the popular observance of the law, is negatively correlated with informality. Broadly, Latin American countries follow closely the regression line in these graphs.



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A related view of informality posits that it is the consequence of weak Latin American states that assign themselves an unbearable and unmanageable regulatory load, with a scope that goes beyond their enforcement capacity—what Centeno and Portes (2006) call a *frustrated state*.⁷ Chapters 1 and 2 reviewed the evidence supporting the belief that regulatory barriers to entry are positively related to informality. Djankov et al. (2002) and Loayza, Oviedo, and Servén (2005), for example, find that regulatory barriers to entry are positively related to informality.

Loayza and Rigolini (2006) put several of the elements of this literature in a theoretical framework and hypothesize that the size of the informal sector increases with the regulatory burden but decreases with the efficiency in the provision of services and with compliance enforcement. This long-run relationship is tested empirically through a regression in which informality, proxied by the ratio of self-employment to total employment, depends on the flexibility of the business environment, the quality of public services (such as the prevalence of the rule of law, the efficiency of police and judicial systems), and an indicator of the government's ability to monitor taxes and enforce regulations, proxied by government expenditures as a percentage of GDP.⁸ As generally found in the cross-country literature, GDP explains approximately 80 percent of the variation of this proxy of informality

(table 8.1). The first two variables, business flexibility and law and order, that represent the opportunity cost of informality, and government expenditures (which the authors use as a proxy for the capacity to enforce) that represent the direct cost of informality all have the expected signs and are significant when they replace GDP in the specification. When the four variables are included, significance is lost because of the strong correlation with GDP per capita.

Within the same theoretical framework, a simple empirical exercise was conducted to analyze alternative institutional indicators and alternative variables to approximate informality, namely, the share of the informal economy, the ratio of self-employment to total employment, and the ratio of workers without contribution to pensions or social security to the total number of workers.⁹ Even controlling for GDP per capita, in most cases the institutional variables have a significant and negative sign (table 8.2). The dummy for Latin America is significant in specifications for two of the proxies of informality.¹⁰

A final strand of the literature emphasizes the possible existence of a *captured state*, where a political equilibrium is preserved such that elites (business, public sector, or labor) interact explicitly or implicitly with the state to maintain rents, even if that implies the exclusion of certain segments of the population. The typical situation is that of a populist

TABLE 8.1

Long-run informality relationships

Self-employment rate (as ratio to total workers)	OLS		
	(I)	(II)	(III)
GDP per capita (in logs, annual)	−0.0759*** 0.0043		−0.0516*** 0.0060
Business flexibility (index from Fraser Institute, range: 0–10, country average)		−0.0293** 0.0111	−0.0167* 0.0092
Law and order (as % of GDP, country average)		−0.0457*** 0.0072	−0.0191*** 0.0050
Government expenditure (as % of GDP, country average)		−0.0050** 0.0022	−0.0015 0.0015
Constant	0.9065*** 0.0388	0.6954*** 0.0666	0.9030*** 0.0424
Observations (n)	525; 42	525; 42	525; 42
R ²	0.80	0.72	0.85

Source: Loayza and Rigolini 2006.

Note: OLS = ordinary least squares. Robust, country clustered estimations, standard errors.

* significant at 10 percent.

** significant at 5 percent.

*** significant at 1 percent.

TABLE 8.2

Indicators of informality and institutional indicators

Indicators	Definition 1: Share of informal Economy			Definition 2: Share of self-employed			Definition 3: Share of persons without access to pension		
	(I)	(II)	(III)	(I)	(II)	(III)	(I)	(II)	(III)
GDP (in logs)	-5.23 (3.72)***	-3.12 (2.20)**	-3.83 (2.49)**	-7.88 (5.55)***	-7.60 (5.05)***	-6.68 (4.41)***	-22.70 (10.41)***	-21.67 (9.11)***	-23.53 (9.28)***
Regulatory quality index	-3.42 (1.96)*			-3.44 (2.00)**			-5.59 (2.07)**		
Rule of law		-6.19 (3.69)***			-3.60 (2.05)**			-6.36 (2.33)**	
Government effectiveness			-5.03 (2.78)***			-4.82 (2.75)***			-3.79 (1.28)
Latin America	8.89 (3.27)***	6.34 (2.33)**	7.52 (2.74)***	2.45 (1.07)	0.71 (0.28)	0.74 (0.31)	14.06 (3.69)***	11.97 (2.99)***	13.61 (3.38)***
Observations (n)	110	110	110	60	60	60	98	98	98
R ²	0.47	0.52	0.49	0.74	0.74	0.75	0.82	0.82	0.81

Source: Author's estimates, based on *World Development Indicators* and *Worldwide Governance Indicators*, 2005.

Note: Absolute value of *t*-statistic is shown in parentheses. Regulatory Quality Index: higher values correspond to a more effective regulatory policy.

* significant at 10 percent.

** significant at 5 percent.

*** significant at 1 percent.

government, with a political base in the middle and low-middle class, that is unwilling to eliminate subsidies to public services, even if that crowds out expanding the services to poorer segments with less political clout.

The tax side of the social contract in Latin America

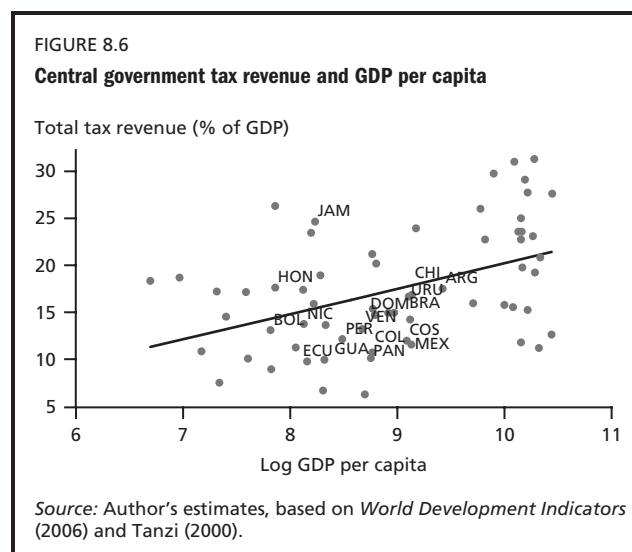
Tax compliance is one of the main components of the decision to engage in the formal economy. In fact, as mentioned in chapter 6, some of the private “benefits” of informality are related to cost savings derived directly from eluding the payment of taxes and avoiding the often complex administrative procedures associated with tax and regulatory compliance. The large informal sector both reflects inefficiencies and inequities of the tax system and defines the magnitude of the challenge to improve tax collection in the region. As long as tax compliance is a social transaction between citizens and the state, it is a key element of the social contract. We review here the main features of the tax system in Latin America and discuss tax compliance behavior and selected policy issues.

Some stylized facts of the tax structure

Tax revenues in Latin America remain below the international norm. Figure 8.6 shows that almost all Latin American countries lie below the regression line relating tax collection to per capita GDP. Lledo, Schneider, and Moore (2004) show that the average tax take has been persistently smaller in Latin America than in OECD countries, while it has been fairly similar to the Asian average (see table 8.3). The median country in the region collects 4 percentage points of GDP less than would be expected, given its level of development (Perry et al. 2006). The average figure for the regions stands at 14.2 percent of GDP in 2000–03 (15.8 percent of GDP including social security contributions). Only Brazil, Nicaragua, Trinidad and Tobago, and Jamaica have tax burdens—without social security contributions—above 20 percent. Guatemala, Paraguay, and the República Bolivariana de Venezuela barely reach 10 percent.

Indirect taxes, in the form of taxes on domestic and internationally traded goods and services, represent the bulk of Latin American tax revenues. They make up about

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60 percent of total tax revenues—almost twice as important as taxes on income, profits, and capital gains. By comparison, in developed countries tax revenues from international trade and from domestic goods and services make up 40 percent of total tax revenues (see table 8.4). Undertaxation of income, wealth, and property is a persistent characteristic of Latin American tax systems. In Latin America, direct taxes are about a third of tax collections; in Europe, half; and in North America, that share reaches 80 percent. All the difference is explained by individual income taxes. These are a third of total tax collections in Europe and more than 60 percent in North America. In Latin America, the share is in the single digits—lower than any other region of the world. The share of corporate direct taxes, however, is not small, and it is only below that in Asia. This situation is a reflection of a very low capacity to

observe and monitor incomes; and it is consistent with a concentration of taxes on businesses, presumably medium-size and large businesses that are easier to monitor. The percentage of corporate income tax revenues triples the percentage of personal income tax revenues. Further, when benchmarked by GDP per capita, Latin American collections of personal income taxes appear unduly lower than those in comparable countries. It is interesting to note that in all regions, except Latin America and Africa, direct taxes have increased their share during the last decades.

Tax collection has been rising modestly in most of Latin America since the early 1990s (Lora 2006b). Most of the increase in tax collection since the late 1980s is explained by value-added tax (VAT) collections, which increased from 2 percent of GDP in the mid-1980s to an average of 5 percent in 2003,¹¹ becoming one of the most important sources of revenue for governments in the region. The income tax collection, however, remained flat at around 4 percent of GDP during the same period, while revenues from trade, excise, and other taxes fell sharply (figure 8.7).

Part of the trend observed in VAT collection is related to a small increase in the VAT rate since the mid-1980s, reaching a median rate of 15 percent by 2003 (figure 8.8). There is still great rate disparity in the region, with rates ranging from 5 percent in Panama to 25 percent in Brazil. Tariff tax rates and dispersion fell sharply as a consequence of trade liberalization.

Corporate and personal income tax rates also experienced important changes. Corporate rates decreased from 41 percent in 1985 to 29 percent in 2003. To encourage investment in an environment with higher capital mobility, these rates were set below the maximum rate in developed economies. The personal income tax shows quite

TABLE 8.3
Comparative perspective of tax burdens and structures (percent of GDP)

Economic region	Tax revenue		Direct		Domestic indirect		International trade	
	1975–85	1986–97	1975–85	1986–97	1975–85	1986–97	1975–85	1986–97
OECD	28.3	34.2	9.9	12.4	8.6	10.5	1.0	0.5
Asia (South and Southeast)	14.0	15.8	5.3	5.6	4.2	5.8	4.0	3.4
Africa	17.6	18.8	5.7	6.3	4.3	5.7	6.4	5.6
Latin America	14.9	15.2	3.8	3.4	5.0	5.5	3.1	2.2
Caribbean	23.3	22.4	6.4	0.0	6.7	6.2	6.3	5.4

Source: Lledo, Schneider, and Moore 2004.

Note: Total tax revenue includes social security contributions.

TABLE 8.4

Tax structure by region, selected years, 1975–2002 (percentage of total tax revenue)

Region	Income taxes			Domestic goods and services			International trade
	Total	Individual	Corporate	Total	General consumption	Excises	
<i>North America</i>							
1975–80	78.4	56.9	20.5	15	7.7	6.5	6.6
1986–92	78.8	63.5	14.4	17	9.8	6.3	4.3
1996–2002	83.3	66.3	15.8	14.8	8.8	5.1	1.8
<i>Latin America</i>							
1975–80	32.7	11.1	17.6	40.4	17.1	19.3	26.8
1986–92	31.1	8.5	17.6	47.3	20.9	21	21.5
1996–2002	30.4	6.2	18.5	56.3	34	16.1	13.3
<i>Western Europe</i>							
1975–80	42.7	33.3	8.5	50.6	28.6	16.5	6.7
1986–92	43.4	32.9	9.3	53.4	33.4	14.9	3.2
1996–2002	47.2	32.8	13	52.4	31.8	15	0.3
<i>Asia</i>							
1975–80	38.8	22.9	20.5	37.2	14.3	18.3	24.1
1986–92	39.3	20.8	19.2	39.5	17.4	16.7	21.2
1996–2002	46.9	24.2	21.4	40.2	19.6	15.3	12.9
<i>Africa</i>							
1975–80	32.1	14.6	16.1	29.7	18.4	13.5	38.2
1986–92	27.4	14.6	11.4	31.9	18.3	11.9	40.7
1996–2002	30.7	17.7	11.6	36.2	21.8	11.3	33.2

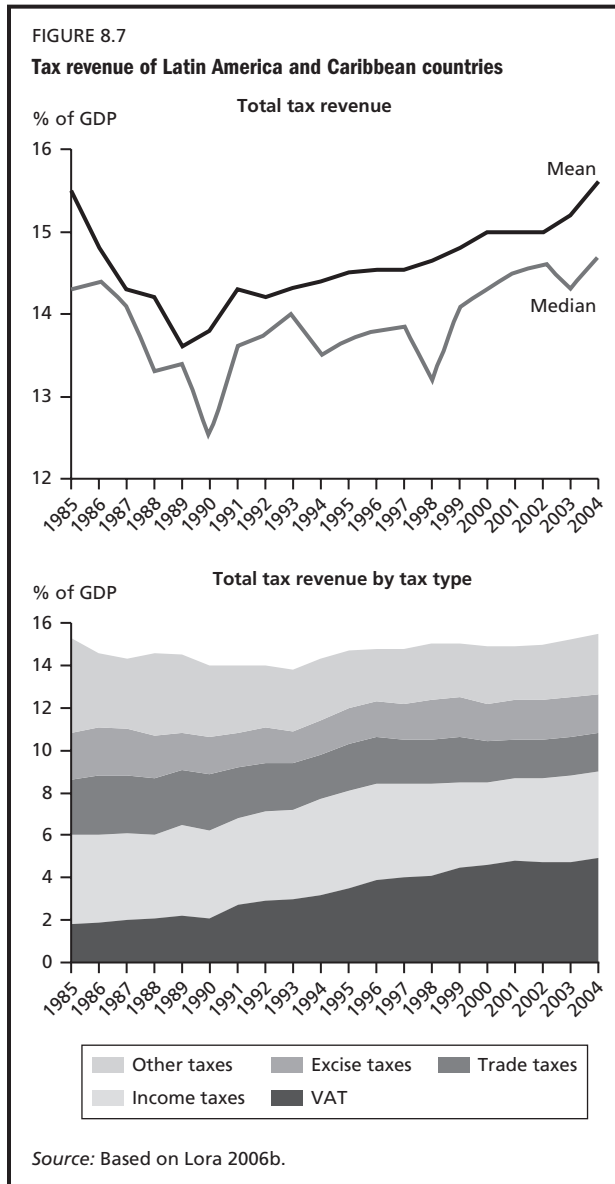
Source: Bird and Zolt 2005.

varied approaches in the region. For example, Bolivia has a flat rate tax of 13 percent, whereas Colombia has a number of progressive rates (132 in all), ranging from 0.26 percent to 35 percent; Chile similarly has a very progressive schedule with eight brackets and with minimum and maximum rates of 5 percent and 40 percent, respectively. Personal income maximum rates also decreased sharply in the period. On the other hand, personal exemption levels increased from an average of 60 percent of GDP per capita in 1985 to 230 percent in 2003 (an unusually high level by international standards), and the income levels taxed at maximum rates (the cutoff for the upper-income bracket) were lowered sharply. It is important to note that, in some countries, the personal income tax exemption allows not only for the poor but also for many middle-income and rich workers to be exempted from income taxes.

Overall tax productivity (the ratio between real and potential tax collection, given the basic or maximum rate) has increased during the last 15 years. VAT productivity

rose from 24 percent in 1985 to 34 percent in 2000, while income tax productivity also increased but at a lower pace (figure 8.9). These average figures show still very low levels in the region, although they hide a great deal of heterogeneity. There is great disparity in the region in the overall effectiveness in using the existing tax structure. For example, as shown in figure 8.10, VAT productivity ranges from a high of 0.64 in Chile to a low of 0.17 in Guatemala.

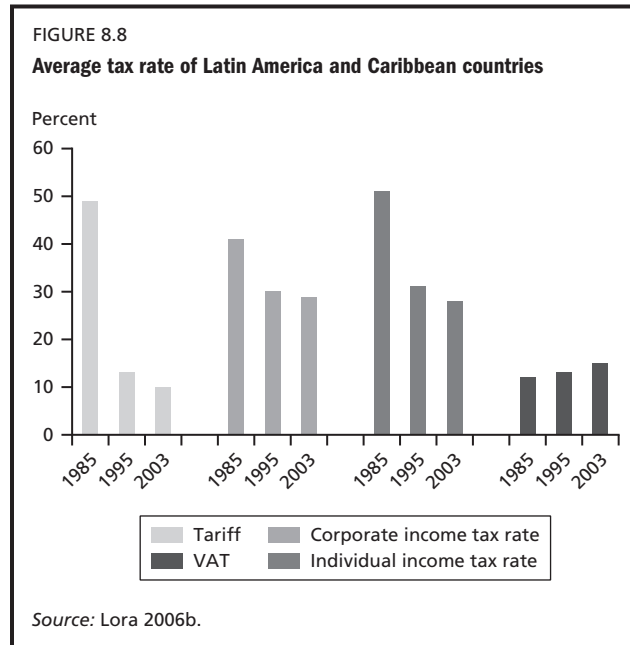
Differences in productivity across countries are probably linked to different VAT structures and to tax expenditures (that is, to multiple tax exemptions and to deductions granted to specific sectors, particular geographic regions, or, in some cases, to specific taxpayers (see table 8.5), as well as government's ability and willingness to administer efficiently the existing taxes. Exemptions are particularly pervasive in the region and are a manifestation of state capture by specific groups. In addition to direct loss of revenues, these loopholes and distortions usually create opportunities for tax elusion. There are also important differences



in the administration capacity. Chilean tax administration practices would appear to be over three times more effective than those in Guatemala in raising VAT revenues (Alm and Martinez-Vazquez 2007).

From a different perspective, the productivity of VAT is undercut by informality and difficulty in bringing small businesses and individuals supplying certain services into the system. As observed, there is a clear inverse correlation between VAT productivity and informality (figure 8.10).

So the relatively low level of tax collection in Latin America is a result of tax systems characterized by poor capacity of tax administration, excessive exemptions, and narrow tax bases. As will be discussed in the following section, however, the rich in Latin America pay a much larger share of taxes than the share paid by the rich in developed countries.

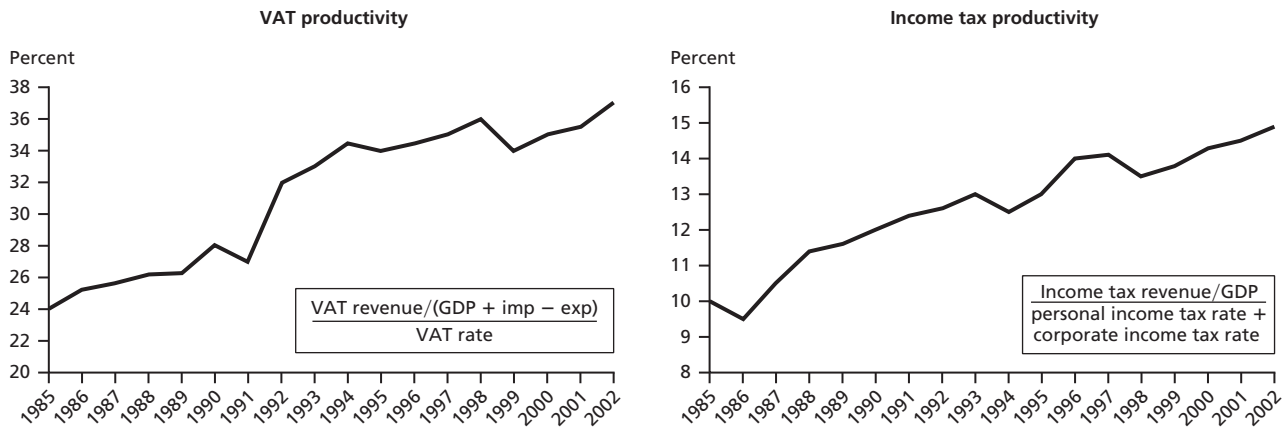


The cross-country literature also supports the view that the higher the tax burden, the larger the informality. In cross-country studies, Johnson, Kaufmann, and Zoido-Lobaton (1998), using indicators of perceptions of the tax burden—including both how high tax rates are and the discretionary power of authorities in administering and operating the system—find a large positive effect on informality. They also show that what matters to explain informality are the administration and operation of the tax system rather than the established rates as a key correlate. Friedman et al. (2000) find that higher tax rates are not correlated with a larger informal sector. In fact, the opposite might be true: countries with high tax rates may be those with high benefits of formality.

Tax compliance behavior

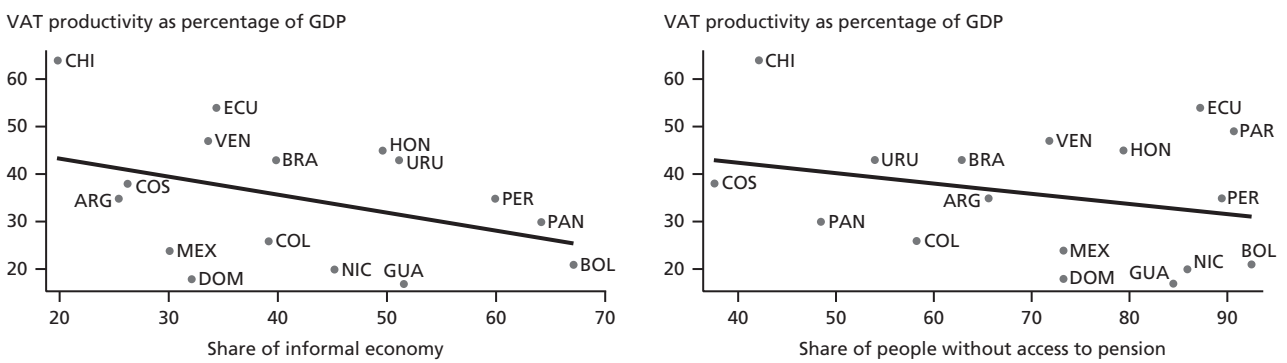
From a utilitarian viewpoint, individuals regard tax obligations casually and display no particular moral aversion to evading if they feel they can safely do so. The taxpayer is an isolated expected utility maximizer who makes rational portfolio decisions under uncertainty, given an informational set. In this view, people pay taxes exclusively depending on their perception of being detected and sanctioned (Alm et al. 1995; Cowell 1990). They do not relate tax payment to perceptions of the quality or fairness of the public services received, to perceptions of a moral obligation, or to any social norm. If enforcement is weak and the possibility of a sanction is low, predicted tax evasion would be high. The policy implication of this approach is that

FIGURE 8.9
Average VAT and income tax productivity in Latin American countries



Source: Lora, Cardenas, and Mercer-Blackman 2005.

FIGURE 8.10
VAT productivity and informality indicators



Source: Author's estimates, based on Alm and Martinez-Vazquez (2007), and World Development Indicators, 2005.

TABLE 8.5
Tax exemptions in Latin America (percent of GDP)

Country	Total
Argentina	2.4
Brazil ^{a,b}	1.4
Chile	4.2
Colombia	9.2
Ecuador	4.9
Guatemala	7.3
Mexico ^a	6.3
Peru	2.5
Uruguay	5.3

Source: Based on Gómez-Sabaini 2005.

Note: GDP = gross domestic product.

a. Corresponds to federal or central government.

b. Contributions from profits and social security are included.

compliance with taxes—and presumably with most regulations—will depend on the economic consequences of detection and punishment; therefore, greater compliance will depend on deterrence mechanisms.

But tax compliance seems influenced by factors beyond economic ones. For instance, in the United States, the percentage of individual income tax that is audited is quite small, often less than 1 percent; typically, it is even lower in Latin America (Alm and Martinez-Vazquez 2007). And, in any case, very few noncompliance complaints are punished effectively (Tanzi 2000). Given the level of fines and audit rates in most countries, and the available estimates of risk aversion, deterrence models are not able to predict the observed levels of compliance (Alm and Torgler 2006; Feld and Frey 2007), and differences in public attitudes toward

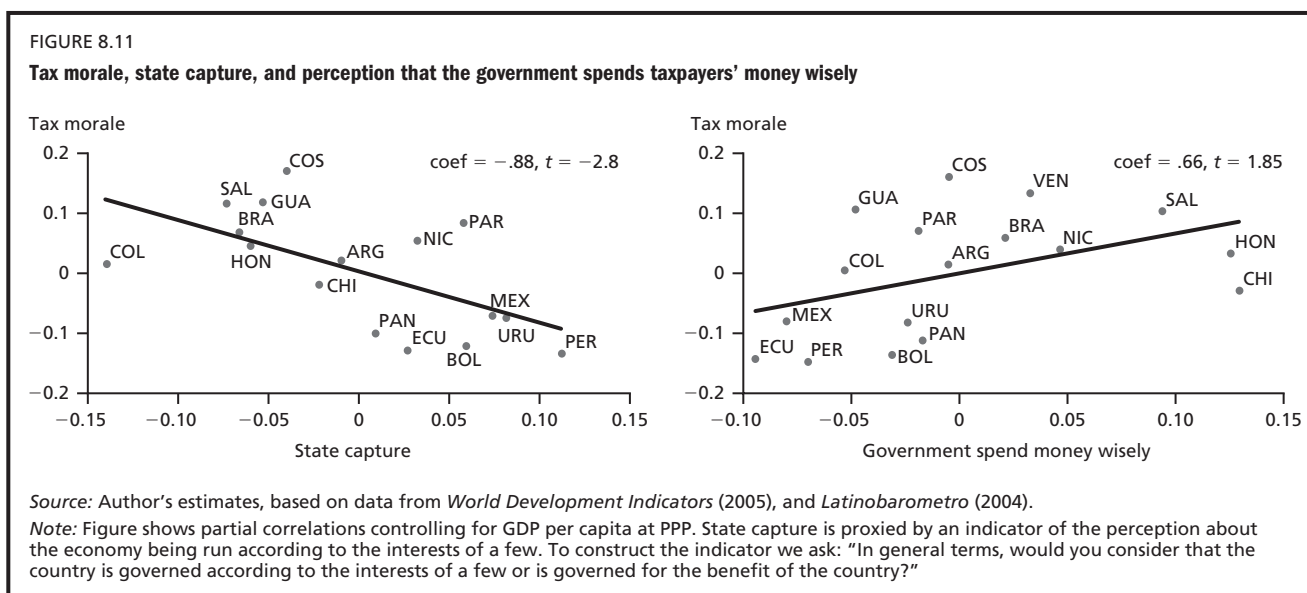
tax laws seem to play a role. In some nations, individuals tend to view paying their taxes as an important civic obligation and, for that reason, are motivated to pay.

An individual's compliance is related to her or his belief that compliance is the social norm. Perception of fairness, trust, and legitimacy in the system might influence a social norm that leads to higher voluntary compliance. Citizens perceive their taxpayer relationship with the state as one of exchange or as a contract. They will avoid taxes if they perceive they are not getting quality government services for the taxes levied on them. Cowell (1990) posits also that the degree of taxpayers' satisfaction with the government affects evasion decisions. If they perceive that this relationship is not in equilibrium, moral costs of evading fall and tax morale is crowded out (Torgler 2005). Using survey and tax return data from a sample of 800 well-off taxpayers in New York, Scholz and Lubell (1998) found that trust in government and in fellow citizens' keeping their side of the social contract significantly influences tax compliance "even after controlling for the influence of any internalized sense of duty and self-interested fear of being caught" (p. 412). Bergman (2002) discusses the contrast between northern Europe, where tax evasion historically has been lower than in Italy, Greece, and Portugal. He also discusses how, on the Iberian peninsula, democratization and the expansion of the welfare state led to improvements in compliance. This strand of the literature views tax compliance as influenced by a "social exchange," a social transaction

between states and citizens and, as such, views this exchange as the "bedrock of the social contract" (p. 290).

These social norms of tax compliance are measured in the empirical literature by what is termed *tax morale*.¹² For example, Torgler (2005) performs a multivariate analysis of tax morale for Latin America using data from the *Latinobarometro*. The 1998 data come from approximately 15,000 individuals in 10 countries in the region. He finds that Mexico stands out as a country with low tax morale, while South American countries generally have lower tax morale than do Central American and Caribbean countries. Also, he shows that a large majority of individuals perceive tax collection as largely arbitrary and unfair (only 23 percent of those surveyed by *Latinobarometro* in 2003 thought tax collection was "impartial"). Spicer and Becker (1980) provide evidence of a "fairness effect" whereby those who believe they are not being treated fairly by the tax system are more likely to evade.

Cross-country data provide suggestive evidence of the relationship between willingness to comply with tax regulations and perceptions of government's performance. Figure 8.11 shows a clear negative correlation between tax morale and the perception that the government is run according to the interests of a few, a measure of state capture. There is also a positive correlation between tax morale and the perception that the government spends taxpayers' money wisely. In both cases, correlations are significant even after controlling for GDP.



But perceptions of individuals regarding the effectiveness and fairness of state actions may change through time. For example, Martinez-Vazquez and Torgler (2005) studied changes in tax morale in Spain, using data from the World Values Survey and the European Values Survey, to analyze the evolution at four benchmark years: 1981, 1990, 1995, and 1999/2000. Spain has undergone fundamental changes in the role and effectiveness of the public sector since its

transition to a democratic system after 1975 and after joining the European Union. The country has adopted major tax policy and tax administration reforms, an extensive redirection in public expenditures with the development of a social welfare system, and a significant push for decentralized governance. Martinez-Vazquez and Torgler argue that Spain succeeded in designing general institutional reforms, including tax policy and tax administration reforms, as well

BOX 8.2

Local taxation and social norms

Sokoloff and Zolt (2005) maintain that, in the 19th century, North American and Latin American economies raised national/federal-level taxes in a very similar way, with high reliance on trade and excise taxes. Where the two areas differed was in taxation at the local level. Local governments were far more prominent in North America, and they relied for their revenue primarily on property taxes—a fact that suggests a rather progressive taxation structure. Local governments grew on the basis of these resources and were given by local communities the task of providing public education and investing in roads and other infrastructure. This dynamic suggests closer local control, higher accountability, and the generation of a social norm that induced people to pay taxes. In Latin America, local governments were much smaller, and both local and provincial or national governments did not rely on property taxes; rather, they relied on mechanisms that placed a smaller relative burden on the elites (see table 8B.1).

In the 20th century in North America, the federal government's share of taxation started to increase, and, at both the national and the local levels, the structure of taxation shifted to one that relied on property, income, and sales taxes. In Latin America, however, local governments and local taxation never grew significantly. Most of the increase in taxation there occurred at the national level and was much more timid. As shown in table 8B.1, there was basically no significant increase in the tax take as a percent of gross domestic product during the first six decades of the 20th century, and only between the 1970s and the 1990s was there some increase. This increase in taxation involved greater reliance on consumption taxes in the period, reaching basically half of the tax collection in the 1990s. Property taxes made a very small contribution to revenues collected.

TABLE 8B.1

National-level government tax revenue in Latin America, 1900–2000 (percent of GDP)

Country	1900	1910	1920	1930	1940	1950	1960	1970	1980	1990	2000
Argentina	10	7	5	7	8	10	10	8	13	10	14
Bolivia	—	—	—	—	—	—	5	10	5	14	18
Brazil	10	11	9	8	10	7	7	10	10	24	23
Chile	—	—	—	—	9	11	17	16	32	21	24
Colombia	—	—	—	—	4	7	8	10	12	13	14
Costa Rica	—	—	—	—	—	10	12	14	18	23	21
Mexico	5	4	—	6	7	9	8	9	16	16	15
Peru	—	—	—	—	—	11	16	16	17	13	16
Uruguay	—	—	—	—	—	—	—	—	22	24	28
Venezuela, R. B. de	—	—	8	9	12	18	27	19	26	24	20

Source: Sokoloff and Zolt 2005.

Note: — = not available.

as in changing the extent to which citizens identify themselves with the state and the national institutions of the country itself—processes that had a strongly positive effect on tax morale and practically doubled the tax effort for general revenues in the country (from 22 percent of GDP in 1976 to 40 percent of GDP in 2002). Concomitantly, a major increase in formal employment was observed during the 1990s, and tax revenues collected from small firms increased dramatically (Farrell 2006).

The cross-country correlations presented above suggest that willingness to pay taxes is related to perceptions about the performance of the state, among other things. Bergman (2002) goes a step further and tries to test explicitly tax compliance at the country level using micro data surveys in Chile and Argentina. He finds that, in Chile, citizens comply more and are more willing to abide by the rules. Confidence in public institutions generates trust in their ability to use public resources to fund social policies and fight poverty. In Argentina, on the other hand, there is lower satisfaction with less trust in public institutions, and this is behind the observed lower levels of solidarity (see box 8.3).

In a related report, Bird, Martinez-Vazquez, and Torgler (2006) explore the role of governance and, more generally, the quality of the responsiveness of governments to citizens' demands over tax effort. Their basic hypothesis is that although traditional "supply factors" (such as trade openness, sectoral composition of output, GDP per capita, and structure of tax bases) clearly matter in explaining tax effort, there is also a need to account for citizen attitudes in response to government performance as shaped by societal institutions. To account for such "demand factors," or societal institutions, they study the explanatory power of quality of governance indicators (including government effectiveness, rule of law, control of corruption, regulatory quality, and voice and accountability). Using a cross-section of developed and developing countries, and controlling for the above-mentioned supply factors, they show that these "demand" factors matter and that the quality of institutions have a strong positive effect on tax effort.

In addition to this "social exchange" mechanism—that is, I comply because I trust in the state, and the government is responsive, and so I have a moral obligation—tax compliance decisions are also affected by social interactions (Andreoni, Erard, and Feinstein 1998). In a multi-country study of tax compliance, Cowell (1990) reports, "These systematic differences among countries and among groups within one country cannot be dismissed as innate

differences in taste or temperament. Inconvenient though it might appear for neat, individualistic models of economic behavior, people do seem to take into account the 'climate' within the group or groups to which they belong" (p. 102). This relates to the literature of *strong reciprocity*, which is the behavior of so-called emotional and moral reciprocators who condition their contributions to collective goods on the contributions of others, even in fleeting transactions with multiple actors whose behavior they cannot keep track of and whose identities they can never discern (see also Falk and Fischbacher 2005). Schelling (1978) initially posited the idea that interdependent behavior can generate multiple equilibria through a "social multiplier effect" in which one person's behavior influences his or her neighbor's behavior (Glaeser, Sacerdote, and Scheinkman 2003).¹³ An individual's perception of the extent of evasion is a powerful predictor of compliance behavior: the higher an individual believes the rate of tax cheating will be, the more likely he or she is to cheat as well. Individuals prefer to contribute if they believe others are inclined to contribute, but free-ride if they believe that others will do so (see, for instance, Alm, Sánchez, and De Juan 1995; Andreoni, Erard, and Feinstein 1998; Kahan 2005; and Sheffrin and Triest 1992). These behaviors that condition tax compliance and the incentives to informality on "what others do" tend to generate strategic complementarities:¹⁴ if more people operate in the informal sector, it might be easier for anybody to do so; for a given level of state enforcement, an individual will be less likely to be sanctioned if other people also evade taxes. Conversely, given specific changes in tax policy, each person's tax compliance might increase not only because of the policy change, but also because of the change in peers' behavior. Levi (1998) provides a double contingency approach: citizens will pay taxes according to a social norm of reciprocity between taxpayers and the state; at the same time, they will comply based on the perceived fairness of a collective behavior.¹⁵ Using data from *Latinobarometro*, Torgler (2005) finds that knowing about other individuals avoiding taxes has a significant negative effect. He finds that if people trust that others will obey the law and if people trust the president of the country, tax morale is higher.

The interaction of trust among individuals, a perception of fairness in existing institutional arrangements, and a perception that the state fulfills its part of the social contract do not seem to hold in Latin America, and the state

BOX 8.3

Tax compliance, social norms, and trust in the state: The contrasting cases of Chile and Argentina in the late 1990s

Bergman (2002) contributes to the literature on compliance by providing us with two interesting case studies. He uses a multivariate ordinary least squares regression to determine the relationship between trust and perception variables taken from surveys conducted in Chile and Argentina and the “reported willingness of taxpayers to comply with taxes in order to fund social policies” (p. 294).

The surveys Bergman used were conducted in Argentina in 1997 on a sample of 549 individuals, and in Chile in 1998 on a 1,200-person sample. In both countries, 70 percent of the active population paid taxes. In the 1990s, Chile’s level of value-added tax (VAT) evasion averaged 22 percent, compared with a rate of 55 percent in Argentina during the same period. Seventy percent of Chilean taxpayers report VAT evasion as very hard or somewhat difficult. This is in contrast to 67 percent of Argentines who “agree or strongly agree with the statement, ‘People think that in this country evading taxes is easy’” (p. 269). In addition, both countries show a different prioritization of social welfare. In Chile, 76 percent of respondents somewhat agreed or totally agreed with the statement “I am ready to pay more taxes if they are channeled to benefit the poor.” Argentina’s survey shows wide dissatisfaction with social services. Bergman (2002) reports that Argentines “do not challenge the legitimacy of the tax system” (p. 269), but are dissatisfied with the quality of public services.

Using that information Bergman finds that, in Chile, both perceptions of others’ honesty and disapproval of cheating are correlated with citizens’ *willingness to increase their tax burden*, and are statistically significant (see table 8B.3.1). Trust in public agencies (police, public health, courts, customs, and treasury) also has a positive effect on willingness to pay more taxes. The model does not find any effect on the responses caused by the individual’s subjective estimate of the tax authority’s detection capacity.

In the case of Argentina, the dependent variable is actually less stringent because it inquires only about *the willingness to comply with taxes*—not to increase one’s tax burden—to fund social programs. Satisfaction with the performance of public services (health, education, security, and infrastructure) has a positive influence on willingness to comply; tolerance of cheating has a significant

TABLE 8B.3.1

Determinants of reported willingness to increase tax burden, Chile

Independent variable	Coefficient
Collective perception of honesty	0.079**
It is justified to cheat	−0.130***
Trust in and approval of public services	−0.163***
Perception of detection capability	−0.036
$R^2 = 0.12$	

Source: Bergman 2002.

** significant at 5 percent.

*** significant at 1 percent.

TABLE 8B.3.2

OLS—effects of attitudes and tax experience of the willingness to comply, (controlled for age and gender), Argentina

Independent variable	Coefficient
Satisfaction with public services	0.173***
Tolerance of cheating	−0.211***
Feels guilt at evasion	0.289**
Social sanction by peers if taxes are not paid	0.144**
$R^2 = 0.26$	

Source: Bergman 2002.

** significant at 5 percent.

*** significant at 1 percent.

negative coefficient; and, finally, the detection variable again seems to have no effect. Social sanctions and guilt—variables not available for Chile—show, surprisingly, that there is a lack of social norm and individual guilt to pay taxes (see table 8B.3.2).

Bergman concludes that there is a strong link between citizens’ satisfaction with public services and their willingness to comply with tax responsibilities or to increase their tax share in Argentina and Chile.

Chile has a higher level of “social solidarity” (that is, willingness to pay higher taxes) as a result of the populace’s trust in public institutions’ commitment to alleviating poverty. In contrast, Bergman concludes from the Argentine empirical analysis that the lack of satisfaction and trust in public sector institutions is behind the low levels of solidarity. Moreover, legal enforcement there is perceived as weak, as is social enforcement of norms.

Source: Based on Bergman 2002.

INFORMALITY

might lack the legitimacy for citizens to feel obliged to comply with these regulations. Even if systematic micro evidence is still scarce in the region, the cases of Chile and Argentina suggest a large contrast in the social norm that prevails in those countries. In the same way, attitudes data from *Latinobarometro* suggest that there is high variance of tax morale in the region. Low tax morale leading to tax evasion is related to the Hirschmanian exit option: if the state does not give people public goods that they value, and there is no societal pressure for contributing to or participating in the circuit of taxes and transfers established by the state—and, consequently, there is a social norm of non-compliance—then people will have a strong incentive to go and remain underground. This is illustrated in figure 8.12, which suggests that tax morale is, as a consequence, robustly negatively related to informality in Latin America, using two different indicators of informality. This suggests that countries with high informality tend to be those where the social norm is not conducive to complying with tax regulations. In the case of Latin America, in addition to the problems of perception that the state is weak and does not respond to the interests of the majority, the social norm may be affected by the operation of tax administrative systems. If there is a widespread perception that the government is not willing to fully detect and penalize evaders, then noncompliance is legitimized and the prevailing social norm is reinforced.

Latin American countries currently lack the capacity to enforce tax collection as in OECD countries. In a way, it is a

matter of political will because the technology is available and administrative capacity increases are definitely within the range of options of the much-modernized Latin American tax systems. As an example, in 1947, the United States had a GDP per capita that was lower than the one in Argentina and somewhat above the ones in Chile, Costa Rica, and Mexico in 2000. However, in that year the United States already raised 56.6 percent of its revenues from personal and corporate income taxes (Schmitt 2005). In Latin America, that figure today is 30 percent. In table 8.6, survey data reveal some of the problems faced in Latin America. Levels of bribery and corruption are, in general, higher than in other regions. Underreporting and evasion seem also to be higher, as sales amounts reported to authorities by a typical firm in Latin America are about three-fourths of actual sales, with East Asia and the Pacific the only region where that figure clearly is lower.

There is large scope to increase collection through improvements in tax administration and tax policy. Bird, Martinez-Vazquez, and Torgler (2006), Schmitt (2005), and Tanzi and Zee (2000) discuss several areas where the technology is available, and the challenge is more in the political realm. Among others, Latin American tax authorities have to move aggressively in professionalizing tax administration management and in putting firewalls between tax administration decisions and tax policy decisions. Significant progress has already been made in areas like computerization, control of large taxpayers, and use of withholding systems, together with third-party information. In addition,

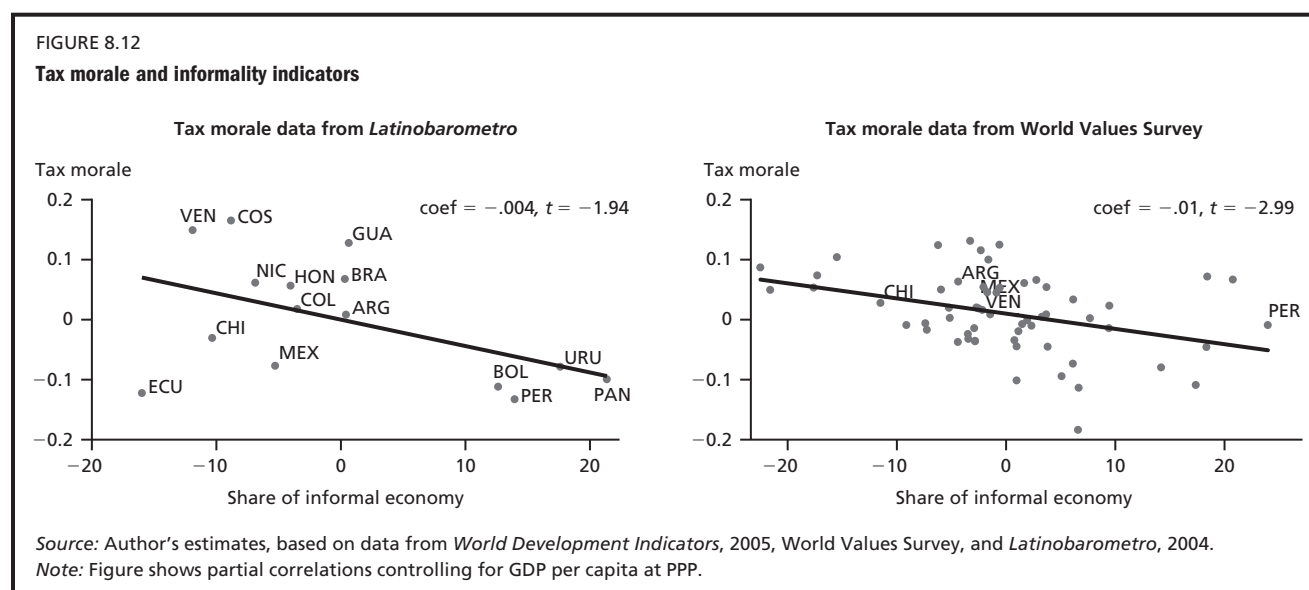


TABLE 8.6

Comparative efficiency and corruption in tax administration: Survey evidence for 2005–06

Indicator	East Asia and Pacific	Europe and Central Asia	Latin America and Caribbean	Middle East and North Africa	OECD	South Asia	Sub-Saharan Africa
<i>Taxes</i>							
Average time firms spent in meetings with tax officials (days)	4.91	2.78	2.89	3.52	1.65	3.37	5.08
Time to prepare and pay taxes (hours)	270.06	437.92	548.80	281.36	197.19	331.71	394.00
<i>Corruption</i>							
Unofficial payments for typical firm to get things done (% of sales)	1.81	0.76	1.48	2.72	0.13	1.28	1.64
Firms expected to give gifts in meetings with tax inspectors (% of total)	33.59	42.84	30.40	40.09	28.26	44.27	18.86
Value of gift expected to secure government contract (% of contract)	1.82	1.36	4.08	1.30	0.55	2.04	3.52
<i>Informality</i>							
Sales amount reported by a typical firm for tax purposes (% of total)	69.30	89.35	76.51	73.55	93.55	93.7	78.39

Source: Alm and Martinez-Vazquez 2007; data from the World Bank Enterprise Surveys.

Note: OECD = Organisation for Economic Co-operation and Development.

in most countries in the region, significant efficiency gains can be obtained by eliminating or lowering exemptions that create loopholes in value-added, income, and property taxes.

But incentives to register with the tax authorities are necessary to increase the tax base—both carrots and sticks. Examples of carrots are programs like the earned income tax credit that provides tax credits to the labor income of families whose annual earnings remained below a certain threshold, often gradually phased out (see box 8.4). These types of programs have had tremendous success in reducing poverty in OECD countries, and have the virtue that transfers are implicitly conditional on the family having someone in regular employment.

Another example of policies oriented to lure the taxpayer is changing the tax administrator's approach to a "service paradigm" so as to enhance its role as a facilitator and a provider of services to taxpayers. This might comprise actions promoting taxpayer education, developing services to assist taxpayers in filing returns, broadcasting advertisements that link taxes with government services, lowering compliance costs, simplifying taxes and their payment, and promoting a taxpayer—and a tax administrator—"code of ethics."

On the side of "sticks," audits and penalties are core instruments of tax enforcement policy. The audit function in most of the region is weak, often underfunded, under-

staffed, and compounded with a legal system too weak to criminalize evasion effectively. Many of the steps that can be taken to improve capacities on this front are technically feasible in almost all countries. Although it is difficult to disentangle their deterrent effects empirically, there is consensus that auditing, fines, and business closures are essential tax enforcement tools. In one of the few studies in Latin America, Bergman (2003) examines the cases of Argentina and Chile, two countries that, as noted before, at the beginning of the 1990s, found themselves with very similar tax policies and macroeconomic conditions but that have since diverged in their tax compliance; today, Argentina has approximately double the VAT evasion of Chile, which is 22 percent. Bergman posits that the key reason for this has been the inability of Argentina's tax system to create a permanent, credible threat to the noncompliant. Argentina has granted a total of 24 major amnesties since 1974, and surveys show that the population believes bribing auditors is common and tax audits have low detection rates. Furthermore, audits in Argentina have been performed almost exclusively on large taxpayers, and smaller firms are aware of that fact. In contrast, Chile has had no major amnesties, and the population perceives it is very hard to bribe auditors. Although it also focuses more on high-level taxpayers, Chile's audit selection system includes in its design a larger number of smaller firms. The efficacy of audits has been very

BOX 8.4

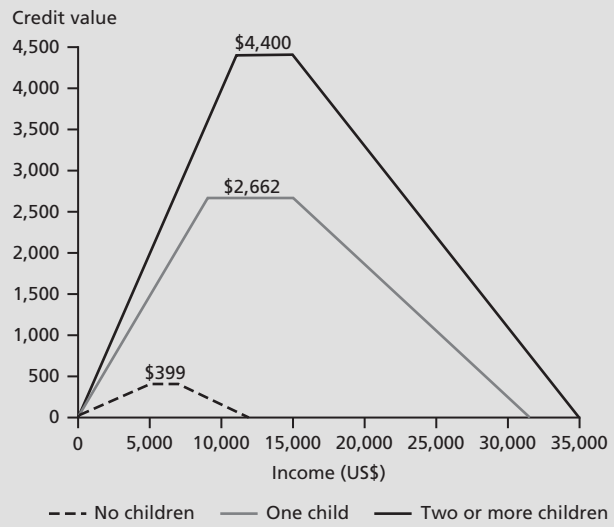
Earned income tax credits: Transfers that encourage formal employment

Fighting poverty and creating incentives to work are challenges faced by many governments. One experience that potentially can offer insights for Latin American countries is the earned income tax credit (EITC). In 1975, the United States introduced an innovative social policy tool that used employment incentives as opposed to public assistance to aid low-income people by providing tax credits to the labor income of families whose annual earnings remained below a certain threshold. More than 30 years later, the EITC has become the largest antipoverty program in the United States: in 2005, 22 million poor working families benefited from the \$34 billion in credit. Other countries, such as Belgium, Canada, France, the Netherlands, New Zealand, and the United Kingdom have since introduced their own versions of earned income tax credits. Using such credits in countries with large informal sectors could induce large segments of the population to register, increasing the ability of the state to observe income for tax or transfer purposes.

The basic design of the credit is this: for each additional earned dollar, workers receive a tax credit, up to an income level considered by the government as the national poverty threshold; after this, the credit plateaus and steadily phases out until an earnings ceiling is reached where eligibility stops. Different thresholds apply to different numbers of children (see figure 8B.4.1). Schedules

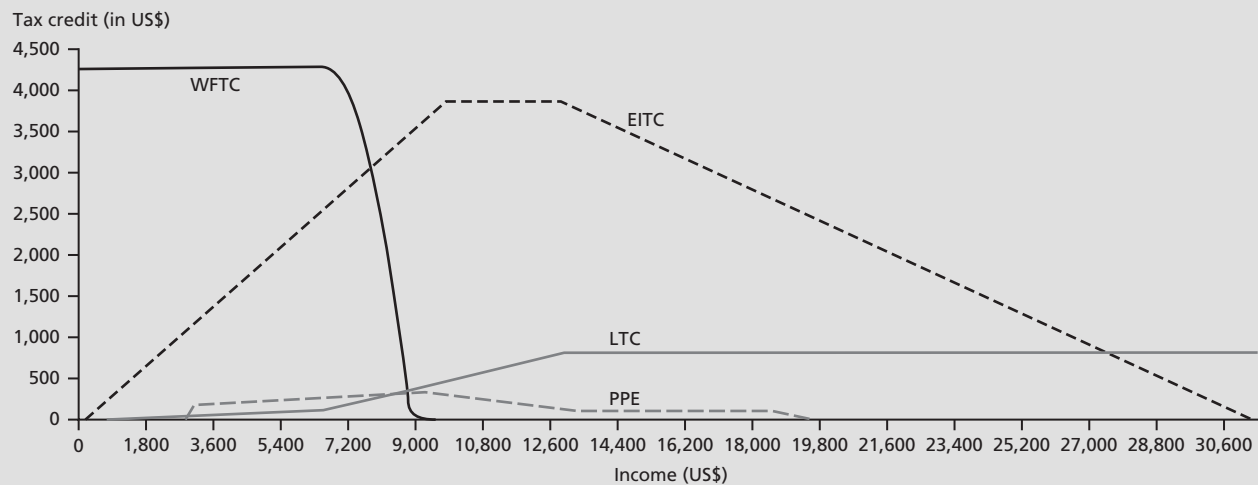
also differ among countries (see figure 8B.4.2); indeed, the Dutch have chosen not to phase out at all when the maximum credit level is reached. Their motivation has been to respond to the key theoretical criticism of the labor tax credit, which is that it might provide disincentives to working or earning more in the phase-out range (Hoffman and Seidman 2003; Hotz and Scholz 2003).

FIGURE 8B.4.1
Value of the EITC, by income, unmarried filers,* 2005



Source: Holt 2006.
Note: Data from Internal Revenue Service. (*) Married couples filing jointly are eligible for slightly higher credit amounts in the "phase-out" range of the EITC.

FIGURE 8B.4.2
Labor tax credits in selected countries, 2001



Source: Detragiache 2001.
Note: WFTC = working families tax credit, UK; EITC = earned income tax credit, USA; LTC = labor tax credit, the Netherlands; PPE = prime pour l'emploi, France.

Other internationally differentiating characteristics are whether the annual credit is refundable or if it applies only to cover one's tax burden, whether families without children are eligible, and whether there is a minimum number of hours one must work to be eligible.

The U.S. EITC has been studied extensively, and the foremost objective of the credit—to reduce poverty—has been a widely documented success. Between 1995 and 1999, the EITC was responsible for an overall reduction in the U.S. poverty rate of 1.5 percentage points (Hoffman and Seidman 2003). Estimates suggest that, without the EITC, the poverty rate among children in the United States would be 25 percent higher (Greenstein 2005). Indeed, the credit has been so successful that, by 2006, 18 individual states in the United States had instituted similar credits for state taxes. The program has also positively affected participation rates among one of the most vulnerable populations in the United States, single mothers. Meyer (2001) finds that 60 percent of increases in single-mother labor participation between 1984 and 1990 are due to the EITC and other tax.

The EITC is not the only tax credit model that seeks "to make work pay." In 1999, the United Kingdom introduced the working families tax credit (WFTC). Brewer et al. (2005) find that the WFTC was responsible for a 5.11 percent increase in the labor supply of single mothers in the United Kingdom between 1999 and 2003. The direct poverty effects of the WFTC have been more ambiguous. A key feature of the WFTC, which has now

been split into the child tax credit and the working tax credit, was that the credit encouraged more hours of work by entitling only individuals working more than 16 hours a week to the credit and providing small additional credit for those working more than 30 hours a week.

The earned income tax credit model's ability to be tailored to fit specific country environments is a characteristic that makes this formula attractive. In the Latin American and Caribbean context, over the medium term, tailored credits could be not only a potent tool for poverty reduction but also an instrument to combat the region's high level of informality. People would have greater incentives to register with tax authorities to receive the credit, providing corresponding incentives for individuals working in informality to exert pressure on their employers to become formal. In addition, disbursement of the credit using official financial intermediaries could be used as a tool to encourage participation in the financial system. In terms of innovative regional design and targeting, we can envision, for example, that poor families involved in the care of the elderly would receive an adjusted credit in the same way that families with children currently do. A primary issue would be the development of good targeting systems in the absence of good income indicators to ensure that the poor are the ones receiving the working credit. Targeting models currently used in conditional cash transfer systems, for example, could provide guidance as to how, in the Latin American context, a working credit initiative could be realized.

different, with Chile focusing on enhancing compliance by matching computerized and third-party information. Argentina relied more on penal sanctions that end up being less effective, given the low expected probability of being detected.

Bergman (2003) provides complementary evidence of the specific impact of audits on tax evasion in Argentina. He finds that, in both Argentina and Chile, audited and sanctioned taxpayers decreased their future compliance in subsequent years, presumably in an effort to recoup the losses prompted by the audit fines, but the decrease was more moderate in Chile. The author attributes this to the fact that, in Chile, the threat posed by the tax authorities is considered credible, as discussed above. The conclusion of this analysis is that tools of deterrence may have unforeseen

effects on tax evasion in a country where tax authorities do not have the ability to produce a credible threat of detection and evenhanded enforcement of sanctions.

Inequality, taxes, and transfers

One of the elements that influence the social norms related to compliance with regulations is the perception of how resources given to the state will be used. On one hand, deficient public services encourage people to opt out of public service systems. On the other hand, a state that is perceived as unfair will lack legitimacy. One element that feeds the perception of unfairness is the real and perceived structure of incidence of taxes and transfers along the income scale. Are taxes excessively concentrated and deemed unfair by some? Are transfers—public expenditures,

in general—excessively concentrated? Are there segment of the population that are excluded from the taxes and transfer mechanism? Are public resources used to equalize opportunities in a way that is consistent with the implicit social consensus? Do they generate an exclusionary mechanism that leaves part of the population out of the social contract and consequently renders the state less legitimate?

We discussed above some stylized facts of the tax side of the equation. As we saw, tax collection in the region is below its expected value, given the level of development. However, social spending does not show a clear pattern. Overall, the ratio of social spending to GDP in Latin America seems to be in line with the region's level of development. There is, however, a large variance within the region (Lindert, Skoufias, and Shapiro 2006). Argentina, Brazil, and Uruguay spend around 20 percent of GDP in social areas, whereas, at the other extreme, the Dominican Republic, Ecuador, Guatemala, and El Salvador show social expenditures below 7 percent of GDP. Mexico stands out as a richer country with relatively low social expenditures as a percentage of GDP. Similar to the small increase in taxes observed since 1985, there is clear evidence of a slightly larger increase in social expenditures. Without exception, social expenditures have increased in all the countries of the region, particularly in countries that started at a low basis in the early 1990s. For the region as a whole, the increase was from 12.8 percent of GDP in 1990/91 to 15.1 percent in 2002/03.

Despite this increase in social spending, patterns of regressivity remain and within-country inequities continue to be very large. In education, spending is mostly progressive, except for tertiary education, and has increased in all countries. But, despite the improvements, quality indicators perform poorly and within-country variance is extremely large. In the case of health care, Latin America has witnessed undeniable progress in the provision of basic services, such as basic health and nutrition services, and indicators like maternal mortality and immunization rates have improved dramatically. But, again, differences in the quality of access by income groups are still extremely large (see de Ferranti et al. 2004; World Bank 2006). Spending on social security, which has expanded the most, is fairly regressive. The pension system is the worst offender, and one of the biggest problems, as explained in chapter 7, is the low coverage. Some social assistance programs are fairly progressive, but, in general, they represent a small fraction of spending. In addition, in Latin America there is abundant evidence of deficiencies and inequities in access to other

services, such as to the judiciary and to police protection. Very much to the point of this report, informal workers are one of the key excluded groups.

In an exercise that aggregates social spending, Breceda, Rigolini, and Saavedra (2007) compare patterns of progressiveness for a sample of Latin American countries with the United States and the United Kingdom. They find that, in addition to significant differences in average levels, there is a strong contrast between Latin America and the United Kingdom in terms of the progressiveness of social spending. In Latin America, social spending is slightly biased in favor of the rich: on average, social spending to the poorest quintile corresponds to 92 percent of social spending to the richest quintile, against 233 percent for the United Kingdom.¹⁶ Latin America seems, therefore, to be closer to the U.S. model, which has a ratio of 107 percent. Although variation in the Latin American sample is quite large (in Honduras—the least progressive state in the sample—the poorest quintile receives 57 percent of what the richest quintile receives, whereas in Colombia the ratio climbs to 108 percent), all countries remain far away from the progressiveness of the European welfare states, and all are less progressive than the United States.

The key element of this discussion for the issue at hand is that there is a large segment of the population for which the state is not providing basic services, for which the state is not a guarantor of minimum opportunities, and for which the provision of public goods is insufficient and, equally important, inequitable.

Inequality and the system taxes and transfers

It is well known that Latin America is the most unequal region in the world, as measured by income distribution (de Ferranti et al. 2004; Perry et al. 2006). Recent research work at the World Bank (2006) has shown that inequality of opportunities is one of the key factors. Differences across individuals in access to assets, public goods, services, and voice (for which individuals could hardly be responsible because the differences arise at the moment of birth) determine differences in their ability to contribute to development and to build their own future. Accumulated differences in opportunities translate eventually, among other ways, to differences in income.

A significant part of the observed inequality is due to the effects of state intervention (or lack thereof) more than to pure market outcomes. As discussed in Perry et al. (2006), if income inequality in Latin America is compared with that

of Europe, there is evidence that a significant part of the difference between the levels of disposable income inequality in the two regions is due to the different impact of taxes and transfers: they reduce market income inequality considerably in Europe, and very little in Latin America.¹⁷ Interestingly, the same can be said even when comparing the Latin American countries with the United States, a country that has the reputation of not being too distributive (Alesina and Glaeser 2004). The inability or unwillingness of Latin American political and economic systems to improve the distribution of income is not a new event, nor has it passed unnoticed by previous observers. For instance, Kuznets (1955) argued about the “the failure of the political and social systems of underdeveloped countries to initiate the governmental or political practices that effectively bolster the weak positions of the lower-income classes” (p. 24; cited in Beramendi and Díaz-Cayeros 2006).

Breceda, Rigolini, and Saavedra (2007) present an incidence analysis of both social spending and taxation for seven Latin American countries, and make the comparison to the United Kingdom and the United States. Consistent with previous studies, they find that, in Latin America, absolute levels of social spending are fairly flat across income quintiles—and in some countries they are even regressive (see figure 8.13). Nonetheless, they find taxation to be quite progressive, particularly income and value-added taxes. On average, the richest income quintile in Latin America pays 22 times more taxes than the poorest quintile. This remains close to the difference in the United States (19 times) and much higher than in the United Kingdom (6 times). Moreover, in Latin America, the share of taxation paid by the richest income quintile averages 61 percent. This remains significantly higher than the share paid by the richest quintile in the United Kingdom (43 percent), and similar to what the richest quintile contributes in the United States (58 percent).

Both features make the structure of social spending and taxation in Latin America closer to that of the United States than to that of the United Kingdom (where social spending is more progressive and taxation is less so). The comparison, therefore, strongly indicates that Latin American countries resemble a minimalist welfare state similar to the one in the United States, more than a Europe-like one. The extremely high inequality levels observed in Latin America make the transition difficult toward a more progressive welfare state. In particular, although the rich in Latin America are taxed equal to or less than the rich in

many European countries (as a proportion of their income), given the high inequality, their contribution to total tax revenues is much larger (despite the elements of state capture mentioned above, including the high level of tax exemptions that, in many cases, favor the rich disproportionately). This may place a strain on the social contract because the richest quintiles have to pay for most of the state provision of public services without seeing sizable benefits in return. These findings give further support to the argument that an increase in the efficiency of the system and an increase in the tax base are the key avenues to increase tax collection in the region.

Other studies that look only at taxes find small progressivity and, hence, a small redistributive effect of taxes in Latin America (Chu, Davoodi, and Gupta 2000). Moreover, Engel, Galetovic, and Raddatz (1999) find that, in Chile, which has the highest tax productivity of the region, taxes are slightly regressive. They argue that the more unequal the pretax distribution—as is the case in Chile and most of the region—the less the redistributive effect of progressive taxation. A lot more is achieved through better taxation, fewer loopholes, and higher levels and quality of spending.

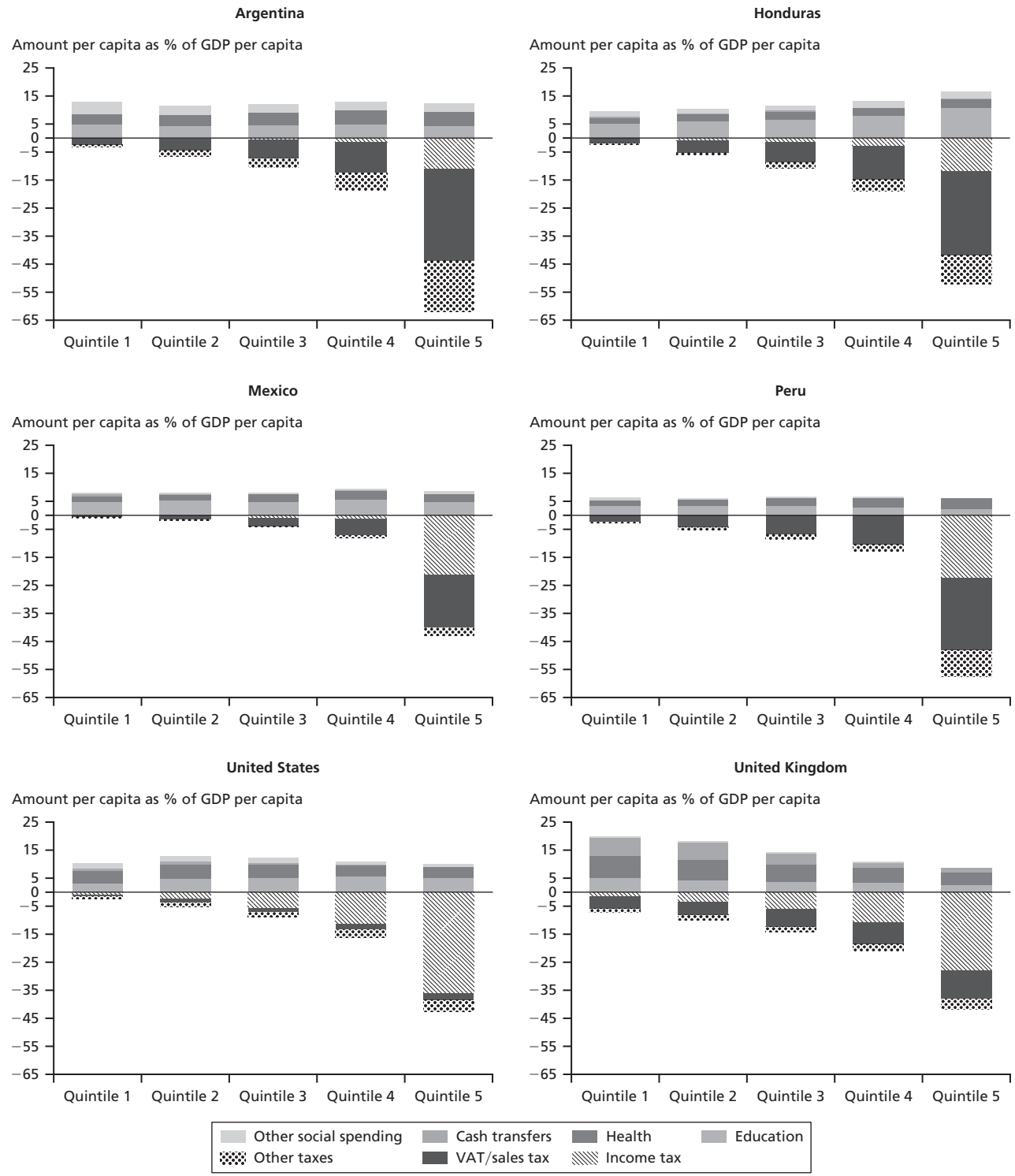
An unfortunate characterization of Latin America is one of low-quality, ineffective provision of public services that reflects an unresolved problem of high inequality of opportunities and is correlated with an extremely high level of inequality of current incomes. This is within a context of a taxes and transfers framework that does not redistribute effectively.

In addition to how inequality interacts with the taxes and transfers structure, there are several channels through which inequality might be linked explicitly to informality, although the intuitive relationship is not well studied yet. Ahmed, Rosser, and Rosser (2004) find that the informal sector share is a significant determinant of income inequality in a sample of 52 countries (as cited in Davis [2007]).

Chong and Gradstein (2007), explore the opposite channel, which is of inequality as a mechanism that generates more informality. They model and test that relationship empirically and find a significant positive relationship. Further, they argue that the effect of high inequality may be exacerbated in the context of low institutional quality. The reason they postulate is that, given market imperfections, when institutional quality is low, protection of property rights in the formal sector is weak and resources largely are up for grabs. “Poor individuals whose endowments are

INFORMALITY

FIGURE 8.13
Social spending and taxation by income quintiles



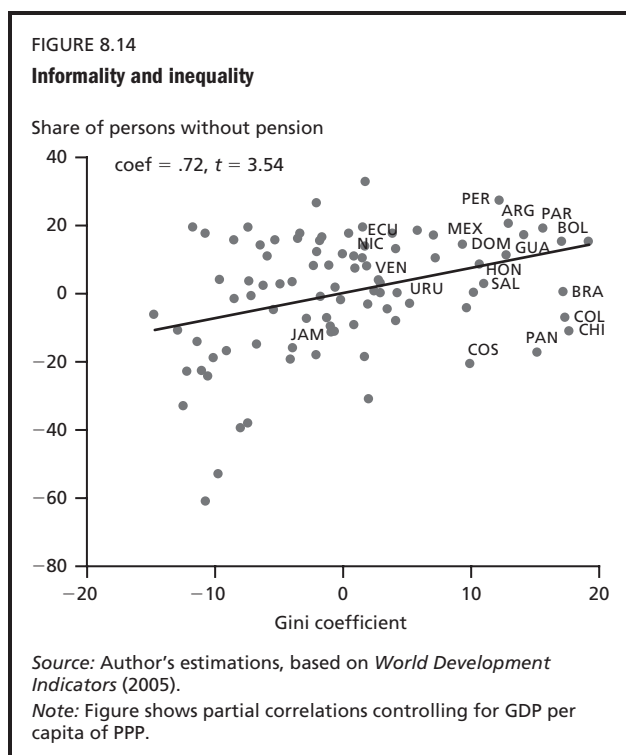
Source: Breceda, Rigolini, and Saavedra 2007.

relatively limited are at a disadvantage in extracting a larger share of the resources, hence, find it beneficial to move into the informal sector, where although less productive, they are able to fully retain their production output. High inequality, exacerbated by low institutional quality, magnifies this effect, implying a positive relationship between inequality and the size of the informal sector” (p. 160).

This result is very relevant in the context of Latin America. Income inequality reflects itself in differences in voice, power, and influence. The lack of influence usually leads to capture and to a perception that the state is run according to the interests of an elite. Among other effects, this leads to lower tax morale and higher informality. Precisely, better institutions might be hampering the possibility that inequality of income may lead to inequality of power.¹⁸ Bird and Zolt (2005) show evidence of a negative effect of inequality on tax effort. They argue that highly unequal distributions of income, typical of Latin America, can lead to low levels of solidarity by the elites toward poorer groups. For example, low tax effort in Central America is often interpreted as the unwillingness of a small elite to finance publicly provided goods because they can opt out and finance their own services.

But an argument that is valid for the elites who might influence policies in their favor is not valid for the relatively rich or the middle class. When there is extreme inequality, it is more difficult to collect revenues in a fair and efficient way. In Latin American countries, despite paying proportionally less than their peers in richer countries, the relatively rich (that is, the small middle class that exists in Latin America) pay a disproportionate share of all revenues. And, given that services provided by the state are of low quality, what they get back from the state is not aligned with what they pay—although they may be getting more service from the state than the poor are getting. This misalignment implies that the opportunity cost of tax compliance is even higher.

We performed several cross-country estimations to test the robustness of the result of a positive relationship between inequality and informality, given the level of development and other institutional characteristics. As shown in figure 8.14, the two variables are positively related after controlling for GDP, and the results are robust to using different informality indicators. We wanted to further analyze whether the effect of inequality is conditioned by institutional characteristics. However, the econometric analysis (not reported) shows that both inequality and GDP are highly correlated with institutional and structural variables that, by them-



selves, can explain a high share of the variation in informality. It is then difficult to disentangle the independent effect of inequality on informality from the effect of institutional variables. The evidence presented by Chong and Gradstein (2007) is suggestive, but more analysis is needed to understand better how the institutional setting may affect the channel through which inequality affects informality.

Informality: A reflection of a broken social contract?

Is Latin America in a “bad” equilibrium?

Economies can land in different equilibria if social norms and social interactions that lead to specific collective behaviors are strong.¹⁹ You make the queue or skip the line. You stop at the red light or you keep moving. As discussed above, tax and regulatory compliance, one of the consummate collective action problems of public policy and a key factor behind informality, may be affected by social interactions. Individuals will be more inclined to pay taxes if they believe the government is complying with its fair share of the social contract and is using public resources effectively. They will be more willing to comply if they believe others do so, prompting still others to comply, and so forth and so on until a highly cooperative state of affairs takes root. Conversely, people will be inclined to evade tax obligations

if they believe others are inclined to do so. Such interdependencies tend to generate patterns of collective behavior with specific reinforcing mechanisms.

Latin America seems to be in an equilibrium in which trust in the state is low; tax collection and compliance with regulations are low in most countries; and public provision of public services is inequitable and of low quality, both directly because of lack of resources and because of low government effectiveness, even given the available resources. This unfortunate characterization reflects an unresolved problem of high inequality of opportunities correlated with an extremely high level of inequality of current incomes. This happens in the context of a structure of taxes and transfers, that does not redistribute effectively.

Low taxes are mostly related to low tax productivity. And, as discussed above, this is mainly related to low tax compliance, narrow tax bases, and excessive exemptions. The empirical analysis presented above suggests that tax compliance is affected by deterrence and by a complex of factual beliefs and emotional dispositions, whereby social norms are not necessarily conducive to complying with taxes and other regulations—a fact that has been proxied by low tax morale. The evidence in Latin America also points to a negative relationship between tax morale and informality. These actually are different sides of the same coin. Low willingness to pay taxes and incentives to operate informally are shown to be empirically correlated with perceptions of incompetence of the state (proxied by indicators of government effectiveness, rule of law, impartiality and fairness of courts, for example). Evidence also suggests the importance of fairness in the use of public resources. In this context, informality is fueled by a structure of regulations that, in a cost–benefit analysis, may provide a rationale for firms and workers to operate underground, as discussed in chapter 5, fostered by a social norm not conducive to complying with regulations and by weak social and administrative sanctions. In this context, there are multiple examples of ways in which both the poor and the rich might feel excluded and find it convenient to opt out, usually partially, from the system.

Opting out . . . but not completely

Telling the story in terms of the beliefs and actions of agents at different levels of the socioeconomic scale, we might say that, in many Latin American countries, the rich, the middle class, and the poor might feel they are not getting a

fair deal—through different mechanisms—by the current arrangements, and that they are justified in avoiding making a contribution to the system whenever possible.

From both ends of the socioeconomic scale we tend to observe a large amount of exit, in Hirschman's terminology. We can use a cost–benefit decision scheme, like the one we presented in the second section of this chapter, now from the point of view of a citizen from the highest income quintile who is considering his or her relationship with the state and with society at large when it comes to deciding whether to evade taxes. In many Latin American countries, such a “rich” citizen is likely to opt out of public services and into the higher-quality private provision of old-age insurance,²⁰ security services, education, and health care. A citizen is likely to feel that such state services are of very little value to him or her. When assessing how valuable such state services are for the population at large, he or she is likely to share the perception that these things that are of little worth to him or her are not useful, effective, of high quality, or fair for citizens in other strata. This negative view of the worth of state services is likely to be compounded by a generalized perception of patronage and corruption in the government generally and in social assistance particularly; and by the social norm externalities that provide an implicit validation of widespread tax evasion.²¹ In some Latin American societies, such as Argentina, we see an increase in socioeconomic segregation, which might bring further difficulties for weaving together a social contract down the road. Poor and rich citizens tend to live in worlds further apart in terms of the schools their children go to, where health services are received, and where their homes are located, with gated communities and shanty towns as clusters, each time placed farther apart.

However, many of the rich, usually the richest of the rich, may also be capturing the state and using its relatively larger influence to maintain tax privileges or lobby to maintain oligopolistic structures. Corporatist groups and certain unions may use political pressure to maintain privileges that perpetuate unequal structures of power and of opportunities. In any of these cases, we are confronting weak and incompetent states—not necessarily small states—on one side, incapable of constraining the influence of powerful groups (Guerrero, López-Calva, and Walton 2006) and, on the other side and related to this, incapable of providing services and public goods in a fair manner.

Poor people feel even more disengaged. The Hirschmanian notion of exit applies also to the lower end of the socioeconomic distribution: the poor do not pay many taxes, but they also do not get much from the state (see box 8.5). They feel an adverse differential access to public goods, to property rights, to protection under the law, and to judiciary services. This fosters the use of informal mechanisms and reduces the incentive to participate in the formal circuit. The poor will organize themselves for self-protection as well, will invade public property, and, in some unfortunate cases, will take justice into their own hands. Poor citizens are more likely than their wealthier neighbors to be informal, to participate in clientelistic networks, and to have a negative view of the state and the extant social arrangement. A difference with respect to the wealthy is that, in many cases, the poor have never been part of the formal system anyway. More than “exiting” the system, the poor have never entered the system. This situation is part of a culture of informality in which the state is basically absent and a social contract is basically broken.

It is easy to see that precisely these attitudes have important reinforcement effects. The low willingness to contribute is part of the explanation of the fiscal limitations that impinge on the low quality and coverage of the services provided by the state and that, in turn, feeds back into low trust in the state and low tax morale, as discussed above. There is no clear evidence that the process of opting out is increasing, but there also is no evidence at all to the contrary. At least it is safe to say that some people opt out (exit) from a more inclusive social contract, while others continue to be excluded from it. It happens not only in the “flat” horizontal sense, but also in a “vertical” sense in which whole groups “collectively” exit through what one might call “local” reciprocity dynamics.

The specific experience regarding all the different aspects of exit and exclusion that are behind the large informal sector in Latin America varies notoriously. Below, we describe briefly three particular cases to illustrate this heterogeneity.

Heterogeneity in Latin America

Most Latin American countries attempted at some point in the 20th century to form a social contract that centered on the labor market, with some strong institutional actors, such as unions. That model, linked to the development model in vogue at the time, provided some progressive

incorporation and looked like the construction of a social contract that allowed for the inclusion of increasing segments of the population. But that welfare system reached full coverage, was strongly stratified, and turned out to be financially unsustainable. Many segments of society, including rural citizens and urban marginal areas, never participated.

As a result of an explicit agenda to improve fiscal sustainability and to insert some “market principles,” that system and the political institutions behind it were reformed. The social security system was reorganized along market principles. It is not clear yet that the new system will imply a fast incorporation of segments that traditionally have been left out. Moreover, the evidence shown in this report and elsewhere points to increasing informality in the 1990s.

But different countries seem to be going in different directions, and societal consensus regarding the potential future path varies. In Argentina, for example, there is evidence of increasing inequities in access to social protection and less clarity about the effectiveness of the current arrangements. One possible reading is that now we have a patchwork of elements of the previous covenant, mixed with the recent add-ons, in the form of social assistance programs that were effective during the time of the crises and efficient in some dimensions, but that have not yet added up to anything coherent, let alone an integrated set of social policies that has garnered societal consensus. Some interactions between increasing informality and a transformation of politics seem to be feeding a negative loop. Countries such as Argentina that, several decades ago, seemed to define crucial political decisions in a centralized bargaining arena defining national policies now are moving to an increasingly territorialized model of construction of political power in which focused social assistance programs, informality, clientelism, and new forms of political participation (such as *piquetes*) seem to reinforce each other.

Chile is a very different case. It is the only economy in the region that has been able to attain very low levels of extreme poverty, with a Chile Solidario program that has more beneficiaries in 2003 than what the *Encuesta de Caracterización Socioeconómica Nacional* survey reported as extreme poor. One of the key—and first—elements of the Chilean process that started with the return to democracy in 1990 was its ability to negotiate a tax reform as one of its first steps. It was able to convince the elites (businesses

BOX 8.5

Expansion of private security services in Managua

Hirschman (1970) posits that when discontent with the performance of an organization to which one belongs, a person has two options: “exit” the organization and find another whose performance is superior, or “voice” one’s dissatisfaction in the hope of prompting the organization to improve. In that framework, the phenomenon of wealthier Latin American citizens seeking alternative health care, education, and security providers is seen as their exercise of the exit option. In a flight to quality, they abandon the state and seek private providers. Such abandonment can have far-reaching effects on the state. Citizens may be less inclined to pay taxes for services they don’t use or value, so the state’s capacity to perform its duties will be weakened. The provision of public security to a nation is one of the oldest and most firmly established responsibilities of the state. Centeno and Portes (2006) aptly describe the state of public security in the region at the dawn of the 21st century in these terms: “In Latin America, the incapacity of the state to protect the citizenry has led to the massive growth of private security services, the withdrawal of the wealthy into fortress-like gated communities. . . . In the absence of credible enforcement of rules, people take things into their own hands . . .” (p. 14).

Rodgers (2004) explores issues of security, criminality, and spatial segregation in Managua, Nicaragua. The city

has seen an annual growth in the rate of crime of approximately 10 percent since 1990. Crimes against people represent the greatest increase—362 percent over 13 years. Rodgers reports that “. . . regionally, the Nicaraguan police force has the lowest number of police personnel per capita and per crime, the lowest budget per crime, the lowest budget per police officer, and the lowest average salaries in Central America. As crime has exploded in the capital so has the private security market” (p. 117). He states that, in 1990, there was one registered private security firm in the capital. This number climbed to 14 in 1996 and was 56 in 2003. In that same year, 9,017 people were registered as private security guards. The increasing trend has not abated, despite the government’s efforts to increase resources for the police force and a 33 percent increase in the number of officers between 2000 and 2005 (Gómez 2005). Recent statistics show that, in 2005, there were 67 private security companies covering 4,153 locations, with 9,329 guards and 6,805 weapons. Gómez delves further into the phenomenon of private security in Nicaragua to reveal a crossover between public and private security provision. He observes that some of the highest-ranking former police officers have become active in providing private security.

The message seems to be that when the state doesn’t deliver, people take things into their own hands.

and high-income earners who would pay about two-thirds of the new tax burden) that, in the midst of uncertainty, it was a small price to pay for the return to socioeconomic peace. The combination of tax reform and explicit social policy objectives made this a step toward building a social contract. The reform was approved by Congress six weeks after the new *Concertación* government started (box 8.6). Chile reformed its pension system and has recognized that the increase in coverage is still too small. It is therefore proposing a package of reforms to the system aimed at achieving universal coverage in a way that would be incentive compatible with keeping individual savings as the mainstay of the system and that is fiscally sustainable (see chapter 7). Trust in institutions is high and tax productivity is the highest in the region. Informality is less than 15 percent. Inequality of income in Chile, however, is still

extremely high and, symptomatically, very high in the policy agenda.

The opposite of Chile might be Guatemala, where trust in institutions is low and the presence of the state in several socioeconomic realms is very limited. Tax collections are among the lowest in the region, and informality is around 80 percent. The peace accord signed in 1996, after 30 years of civil war, included a political pact for the reconstruction of the country; and it established the need for increasing tax collection by at least 50 percent before 2000 (that is, to 12 percent of GDP). The increase in tax collection was earmarked for education, health care, housing, and justice. In 1998, the government rescheduled the agreement. In 1999, a large commission prepared the draft of the new fiscal pact. During 2000, the negotiations among all political parties, the business elites, and other organizations failed,

BOX 8.6

Negotiating tax reform and the start of the social contract, Chile, 1990

In a difficult transition environment, the center-left *Concertación* coalition, which won Chile's first democratic election in 17 years, successfully passed a tax reform bill within the first months of the new party's term, earmarking greater tax revenue for increased social expenditures. Boylan (1996) identifies two main reasons for this unexpected policy success: a willingness to be moderate and an engaged negotiation strategy. The final version of the tax package consisted of four main components. It included an increase in the corporate tax rate from 10 to 15 percent and a change in the progressive income tax categorization system that put more people in the highest bracket. Third, to control tax evasion, the highest contributors in the agriculture, transportation, and mining sectors were no longer taxed on estimated profits but on actual profits. Finally, the VAT increased from 16 to 18 percent.

Boylan (1996) argues that it was crucial that the details of the tax reform were negotiated in extraparliamentary meetings with a targeted group from the major opposition party. The targeted politicians of *Renovación Nacional* (RN), a party whose agrarian base strongly identified with the outgoing regime, were known for their technical competence, consensual approach to politics, and their desire to transform the right into a democratic force. *Concertación* was thus able to develop the tax reform with a small, less hostile faction of opposition, who then sold the reform to the rank and file of their party. This way, by the time the reform was introduced into parliament, it was almost a *fait accompli*.

In addition to this negotiation strategy, led by Alejandro Foxley (then minister of finance), policy success resulted from *Concertación's* willingness to be moderate, as evidenced in the final substance of the reform. Initially *Concertación* wanted to raise the percentage of gross national product tax revenue to 3 percent rather than 2 percent. The RN negotiators pushed for the reduction of the corporate tax increase from 20 to 15 percent. From the RN's perspective, the business elite's foresight that the "social debt" of the years of dictatorship had somehow to be paid and its realization that, compared with other taxes in the region, the proposed taxes were not high played a role in ensuring the successful negotiations and passage of the reform. Finally, *Concertación* accepted the RN's proposed increase in the VAT, thus showing a willingness "to tax their own," not only the business elite. In terms of selling the reform to the general public, the earmarking of the additional revenue to explicit social policy gave a sense that the reform was a step toward building a social contract. Furthermore, Boylan (1996) argues that Chilean tax reform was more than a targeted policy success: the moderate and risk-averse strategy followed by the new government "played a crucial role in soldering the fragile rule-making environment at the delicate moment of regime change" (p. 8).

Source: Based mainly on Boylan 1996.

among other reasons, because of the lack of leadership in the executive (ICEF 2005). Some changes implemented in 2001 were harshly resisted by the business elites, which in that year alone presented 31 constitutional appeals against tax increases. The courts lined up with business interests, and the tax take is still around 11 percent of GDP. No need to continue the narrative. Point made.

Mexico is an intermediate case. Filgueira (2005) classifies it among those dual social states with a large social protection system that covers a bit less than half of the population and with rigid labor legislation that hampers formal job creation. Mexico reformed its private pension system, which has made it financially healthier but has

failed to increase coverage. Minimum pension programs have been launched in several states, and the flagship antipoverty program, *Oportunidades*, covers 80 percent of the poor and is considered an international best practice. But further expansion of minimum pension programs or any other initiative aimed at universalizing social insurance clashes with a hard budget constraint. The Fox administration was never able to pass a tax reform, and Mexico is the OECD country with the lowest tax collection—well below what would be expected for its level of development. Trust in institutions is weak, and the social norm regarding tax compliance is probably behind the low VAT productivity of 24 percent. Organized public sector labor is politically

very strong, and neither labor reform nor public pension sector reform has been possible politically. Still, the country is looking to improve the quality of its public performance, and tax reform is again on the agenda.

Conclusions

We have discussed here that to understand informality it is critical to understand several interaction mechanisms between the state and the citizens. Individuals explicitly or implicitly decide whether and how to engage with the mandates and institutions of the state, weighing costs and benefits and state enforcement capabilities. These decisions are conditioned by social norms shaped by how agents individually and collectively perceive and define a relationship with the state. As documented here, cross-country evidence based on opinion surveys and investment climate surveys, as well as on a few comparative studies, suggests that perceptions of government effectiveness and of the performance of services like the judiciary system in Latin America are below those observed in other regions. And, as summarized here and discussed extensively in the literature, informality is negatively related to institutional quality indicators. This environment is consistent with a social norm that is not conducive to complying with regulations.

Taxation, which lies at the heart of a social contract, is one of the areas that has been most studied regarding the role of social norms. As discussed here, tax morale—a social norm about a citizen's willingness to pay taxes—seems to be correlated with several measures of state performance and with informality, both in Latin America and globally. Low willingness to pay taxes and incentives to operate informally are related to perceptions—supported by reality—of incompetence of the state and lack of fairness in the use of public resources. Moreover, the high and persistent levels of inequality, and the prevalence of a structure of taxes and transfers that is not efficient in leveling the playing field and improving the equality of opportunities, fuel a perception of state ineffectiveness. Many among both the rich and the poor, through different mechanisms, may find it convenient to opt out, which leads to higher informality.

Tax collection is low, given the region's level of development, which reveals that higher levels of taxation might be needed to move toward the path of development. But this begs the question, How and why should taxes be raised when much of the region perceives that the performance of the state is bleak? On one hand, even if the objective of raising taxes is taken at face value, the main challenges are to

expand the tax base, incorporate more citizens in the formal economy, and increase tax compliance. The rich in Latin America contribute a much larger share of the tax collection than what is observed in richer regions, and further increases in tax rates might not be socially tolerable or economically efficient. Furthermore, in attempting to increase tax collection, the region faces the challenge of reducing exemptions, which often is a reflection of state capture. On the other hand, Latin American governments would have to improve their performance—both the quality of their expenditures and the mechanism for citizens to monitor them. Recent mainstream literature is less pessimistic about the effect of taxes (and therefore the size of government) on growth, suggesting that Latin America may be on the side of the curve where taxes, as a whole, may be growth enhancing through the public-goods channel. This implies that increases in both taxes and expenditures in Latin America might be growth enhancing, but only if government effectiveness increases dramatically. This will facilitate establishing the conditions for a gradual change in individual and collective beliefs and attitudes regarding the real and perceived relationship between citizens and the state, which is essential to start reducing the high levels of informality in the region. The strong interest in initiatives to improve government effectiveness suggests that many countries are steering in the right direction.

Reducing informality is a daunting task and a critical development challenge for the region. It requires not only increasing overall productivity and growth in the economy and improving regulations in labor and product markets, but also pursuing a long-term agenda that could move countries faster to a better equilibrium. In other words, it is an agenda that includes building a better social contract from which fewer people are excluded and in which there are fewer incentives to opt out from it. As has been described throughout the chapters of this report and in the ever-expanding body of literature on informality, the policy agenda in the areas of labor, credit, business services, cost of registration, taxes, business regulation, property rights, and access to judiciary service, among others, is critical to making progress in fostering access to the formal economy. Policies in these areas, if designed in a consistent and integrated fashion, can help reduce informality as part of the concomitant process of increasing productivity and incomes. But those policies should be part of a road map so that partial steps might be taken over time, using political windows of opportunity for reform.

Notes

1. The following two sections draw heavily on Saavedra and Tommasi (2007).

2. This discussion also relates to the fact that the willingness to contribute to finance welfare support is heavily influenced by perceptions about how deserving the recipients are, by how “close” the person feels to the recipients (ethnically, culturally, and so forth), and by perceptions about the adequacy of state services and the like (Fong, Bowles, and Gintis 2005; Lindert 2004).

3. This is an example of opting out, which is discussed in more detail later in the chapter.

4. The investment climate surveys used for these calculations contain 11 countries from Latin America (Bolivia, Brazil, Chile, Costa Rica, Ecuador, El Salvador, Guatemala, Guyana, Honduras, Nicaragua, and Peru). The sample contains 42 percent of small firms (20 employees or fewer), 38 percent of medium-size firms (21–100 employees), and 20 percent of large firms (more than 100 employees).

5. Data from the World Bank’s Worldwide Governance Indicators (WGI) database are used extensively in this chapter. See Kaufmann, Kraay, and Mastruzzi (2006). The Government Effectiveness Index is a measure of the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government’s commitment to policies.

6. The Control of Corruption Index from WGI is a measure of perceptions, where corruption is defined as the exercise of public power for private gain, with higher values corresponding to less corruption.

7. They argue that the liberal reforms implemented in the mid-1980s were an attempt to reduce the regulatory intent and, at the same time, increase regulatory capacity.

8. It should be noted that this last variable can be interpreted plainly as the size of the state, which may or may not be correlated with enforcement capacity.

9. Share of informal economy (informality definition 1 throughout the text) is the Schneider measure of the average size of the informal economy. The share of self-employed (informality definition 2) is the ILO measure of self-employed workers in the workforce. The share of person without access to pension is computed based on WDI and Centro de Estudios Distributivos Laborales y Sociales for 14 Latin American countries (informality definition 3). These definitions are similar to those discussed in chapter 1.

10. This is probably capturing Latin American higher levels of inequality because the coefficient is not robust to the inclusion of that variable.

11. This increase is after several years of declining tax revenues caused by low growth, high inflation, and ineffective collection efforts.

12. Tax morale information is collected in the World Values Survey and the *Latinobarometro*, which are representative surveys collected in 80 (worldwide) and 17 (Latin American) countries. At the national level, these surveys have a sample size of at least 1,000 observations per country. Both the values survey and *Latinobarometro* ask the question, “Could you tell me in a scale from 1 to 10 (where 1 is never justified and 10 is totally justified) whether you think it is justified to

cheat on taxes if you have the chance?” Tax morale variables used are expressed as the percent responding that it is never justified.

13. Methodological difficulties in the ability to identify and calculate precisely social interaction parameters, in general, have been discussed in detail by Manski (2000). Glaeser, Sacerdote, and Scheinkman (2003) review the scarce recent empirical work that tries to identify social multiplier effects. Their results suggest that social interactions may be large. They posit that, if one person’s proclivity to certain behavior influences his or her neighbor’s behavior, policy changes to address that behavior will have a direct effect and an indirect one through social influence. “The presence of positive spillovers or strategic complementarities creates a social multiplier where aggregate coefficients will be greater than individual coefficients” (p. 2). Empirically, the estimated ratio of aggregate coefficients (estimated, say, at the city level) to individual coefficients is the social multiplier. The writers apply this approach to three settings. They find that, among Dartmouth University students, one predetermined variable had a bigger impact on joining a fraternity at higher levels of aggregation. Using crime data, they find a very large social multiplier; and, using data on wages and human capital, they find a social multiplier at higher levels of aggregation. Another good overview is provided in Gintis et al. (2005).

14. In game theory parlance, the strategies of players A and B are said to be *strategic complements* if when player A increases a component of his or her strategy, player B will want to do so also. In other words, the cross derivative of the payoff function of B with respect to the action of A and his or her own action is positive. Strategic complementarities, if strong enough, lead to multiplicity of equilibria.

15. The prospect of shame or potential stigma and guilt has a similar effect. The more likely an individual believes it is that he or she will be condemned by others if caught, the more likely he or she is to refrain from evading (Grasmick and Scott 1982; Kahan 2005).

16. The authors make these calculations with and without pensions. These figures exclude pensions because of the problems that exist in calculating how much people who receive the transfer had paid during their working lives. In any case, the inclusion of pensions—even if precisely calculated—will imply that social spending would be even more biased toward the rich.

17. For further discussion, see Goñi, López, and Servén (2006).

18. High quality of institutions may explain the fact that, in Chile, high income inequality is not translated into lower trust in the state, low tax morale, and, consequently, high informality.

19. This section draws heavily on Saavedra and Tommasi (2007).

20. In the specific case of pensions, privatization from pay-as-you-go systems has not always implied an increase in trust in the system and uncertainty about future benefits, and political—and, in many countries, economic—risk has not diminished (Kay 2003; Spiller and Tommasi forthcoming); so “private options” may imply alternatives, such as old-age savings accounts in foreign financial institutions, other assets, or reliance on family networks for the provision of protection in old age.

21. In many cases, like Argentina—and unlike Chile—(Bergman 2002, 2003), there is a negative peer-pressure effect in which tax evasion has wide social acceptance, particularly among the better-off populations.

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