INFORMALITY:
EXIT AND EXCLUSION
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INFORMALITY:
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Informality is a way of life in Latin America and the Caribbean, no matter how we measure it. In some countries, the majority of the workforce is not covered by labor protections; the ubiquitous microenterprises found on every street corner are often not registered with authorities and only partially comply with other regulations; and tax evasion by rich and poor alike is the norm. Although these features of the Latin American and Caribbean landscape are not new, their striking increase in some countries has given new life to the debate concerning what informality tells us about how our economies are functioning.

Informality: Exit and Exclusion, the ninth in our series of regional flagship reports, explores this very heterogeneous sector from a variety of perspectives ranging from a concern with the protection of workers, to the productivity of firms, to the determinants of tax evasion. The report accepts and sheds more light on the exclusionary character of much informality, which leaves citizens outside formal institutions. However, it especially highlights that there is an important “exit” dimension that has been understressed in the literature: workers, firms, and families, dissatisfied with the performance of the state or simply not finding any benefit to interacting with it, opt into informality. Hence, the discussion ranges from the purely economic analysis of microeconomic incentives to reflection on the soundness of the “social contract”—shorthand for how citizens of the region relate to the state and to each other.

It is not surprising, then, that the analysis gives rise to recommendations that span many dimensions of the policy agenda. Because the high level of informality in developing countries more generally is partly due to the low opportunity cost of opening a microbusiness, the gamut of measures to increase formal sector productivity (improving the business climate, fomenting innovation, and so forth) and to increase workers’ skills is important. Labor market reform is also essential because part of the rise in the share of workers uncovered by labor protections in the 1990s appears to be due to the increased burden of labor costs and restrictions in several countries. But reform also needs to extend to remedying the poor design of many social protections that workers find of poor quality, inefficient, and of little value. Hence, shifting workers’ cost-benefit analysis toward engagement with the institutions of the state—both through improving the benefits of being formal and through better monitoring—is critical to reducing their often voluntary entry into informality. Relatedly, although experiments reducing the costs of registering businesses have led to relatively little formalization of existing businesses, the impact on those few businesses appears substantial and progress in this area appears important. All of these reforms need to take place in a context of improving the perception of fairness and efficiency of the state, which is often seen as serving the needs of particular elites rather than the needs of the population. In the long run, this is the only way to change social norms of compliance and reduce the “culture of informality.”

This is a topic that the Latin America and the Caribbean Region of the World Bank has been working on in a sustained way through various regional studies and reports for more than 10 years. The present volume builds on this work, introduces original data sources collected for the
project and new statistical techniques to analyze them, and brings together research done in our partner countries. Both its findings and its policy recommendations are thus grounded in detailed analysis of the reality of the region.

As a final note, this Flagship is the last undertaken under the direction of Guillermo E. Perry, and I would like to thank him for his leadership, insights, and enthusiasm as Chief Economist for the Latin America and the Caribbean Region of the World Bank.

Pamela Cox
Vice President for Latin America and the Caribbean
The World Bank
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## Abbreviations

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<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>ATE</td>
<td>average treatment effect</td>
</tr>
<tr>
<td>AUGE</td>
<td>Acceso Universal para prestaciones integrales y Garantías Explícitas (Plan of Universal Access with Explicit Guarantees)</td>
</tr>
<tr>
<td>BONOSOL</td>
<td>Bono solidario</td>
</tr>
<tr>
<td>BPS</td>
<td>Banco de Previsión Social</td>
</tr>
<tr>
<td>DANE</td>
<td>Departamento Administrativo Nacional de Estadística</td>
</tr>
<tr>
<td>ECINF</td>
<td>Pesquisa Económica Informal Urbana</td>
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<tr>
<td>EITC</td>
<td>earned income tax credit</td>
</tr>
<tr>
<td>ENAHQ</td>
<td>Encuesta Nacional de Hogares</td>
</tr>
<tr>
<td>ENAMIN</td>
<td>Encuesta Nacional de Micronegocios</td>
</tr>
<tr>
<td>ENEU</td>
<td>Encuesta Nacional de Empleo Urbano</td>
</tr>
<tr>
<td>F-I</td>
<td>formal to informal</td>
</tr>
<tr>
<td>FONAHPO</td>
<td>Fondo Nacional de Habitationes Popular</td>
</tr>
<tr>
<td>FONASA</td>
<td>Fondo Nacional de Salud</td>
</tr>
<tr>
<td>F-SE</td>
<td>formal to self-employed</td>
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<tr>
<td>GDP</td>
<td>gross domestic product</td>
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<tr>
<td>ICBF</td>
<td>Colombian Institute for Family Welfare</td>
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<tr>
<td>ID</td>
<td>identity</td>
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<tr>
<td>ILO</td>
<td>International Labour Organization</td>
</tr>
<tr>
<td>IMSS</td>
<td>Mexican Social Security Institute</td>
</tr>
<tr>
<td>INEGI</td>
<td>Instituto Nacional de Estadística, Geografía e Informática (National Statistical Institute [Mexico])</td>
</tr>
<tr>
<td>ISSSTE</td>
<td>Social Security Institute for Mexican civil servants at the federal level</td>
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<tr>
<td>LDC</td>
<td>least developed country</td>
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<tr>
<td>LSMS</td>
<td>Living Standards Measurement Survey</td>
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<tr>
<td>MAROP</td>
<td>Mecanismo de Ahorro para el Retiro Oportunidades</td>
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<tr>
<td>MIMIC</td>
<td>Multiple Indicator–Multiple Cause Model</td>
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<td>MPG</td>
<td>Minimum Pension Guarantee</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<tr>
<td>OLF</td>
<td>out of the labor force</td>
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<tr>
<td>PASIS</td>
<td>Pensión Asistencial</td>
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<tr>
<td>PNAD</td>
<td>Pesquisa Nacional por Amostra Domicilios</td>
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<tr>
<td>PPP</td>
<td>purchasing power parity</td>
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<tr>
<td>RN</td>
<td>Renovación Nacional</td>
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<tr>
<td>RTS</td>
<td>simplified tax regime</td>
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<tr>
<td>SARE</td>
<td>Sistema de Apertura Rápida de Empresas</td>
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<tr>
<td>SE-F</td>
<td>self-employed to formal</td>
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<td>SENA</td>
<td>Colombian Training Institute</td>
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<td>SIMPLES</td>
<td>Sistema Integrado de Pagamento de Impuestos e Contribuciones as Microempresas e Empresas de Pequeño Porte</td>
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<tr>
<td>SME</td>
<td>small and medium enterprise</td>
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<td>TT</td>
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<td>VAT</td>
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