



ISSUES ABOUT INFORMALITY

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**Panel on Informality and
Socioeconomic Performance**

NBER/Fedesarrollo

Bogotá, December 2006



This presentation

- Is Informality mostly an issue of firm size, skills and Development level?
- Is Informality always countercyclical?
- What are the consequences of “excess” informality?
- What are the determinants of “excess” informality?
- Is “excess” informality a multiple equilibrium problem?

Is Informality mostly an issue of firm size and skills?

(Gasparini et al, 2006; Maloney, 2006)

- Informality is highly correlated with size of firm and skills
- Most firms in LAC are very small (*0 to 3 employees*), keep being small or exit, and show low TFP.
- Most small firms do not register because they are “too small to register” (75%) or “benefits of registration are too small” (8%). Only about 14% because costs or time of registration and operation are too high (Mexico)
- Around 40/60% of workers are found in small firms and most of them are unskilled
- Social Security contributions increase rapidly with firm size, but there are significant numbers of employees without SS even in large firms.
- **These are all characteristics of countries with low income per capita**
- Tax evasion decreases only slightly with firm size (ICA's). Most taxes lost through evasion are not due by small firms

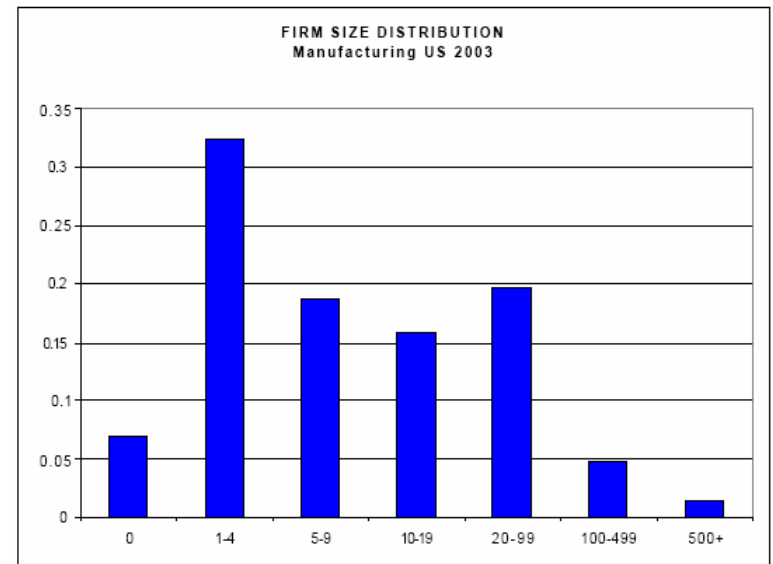
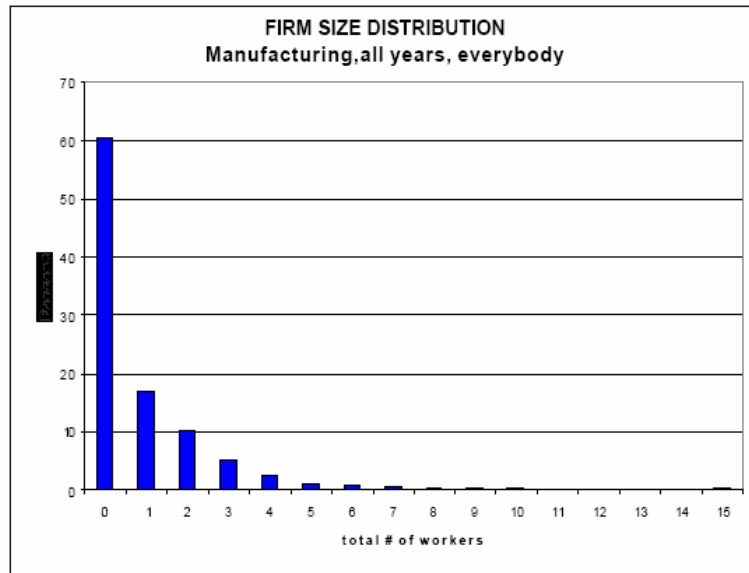
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Informality and Size

Most firms are very small in LAC (Mexico vs US)



Informality and Size

Most firms are too small to register

Table 2: Attitudes towards formalization among unregistered firms

Reasons given for not registering	Mexico	Sri Lanka
Process of registration is too expensive	2.0	2.0
Process of registering takes too much time	8.2	6.4
The additional costs of operating as a registered business are too high	4.1	2.9
My business is too small	75.5	52.0
I don't see the benefits of registering	6.1	7.7
I do not know how to register	6.1	8.0
No business like mine is registered	6.1	12.5
Registration is not necessary	2.0	
Other	8.2	6.1

McKenzie and Woodruff 2006

Informality and Size

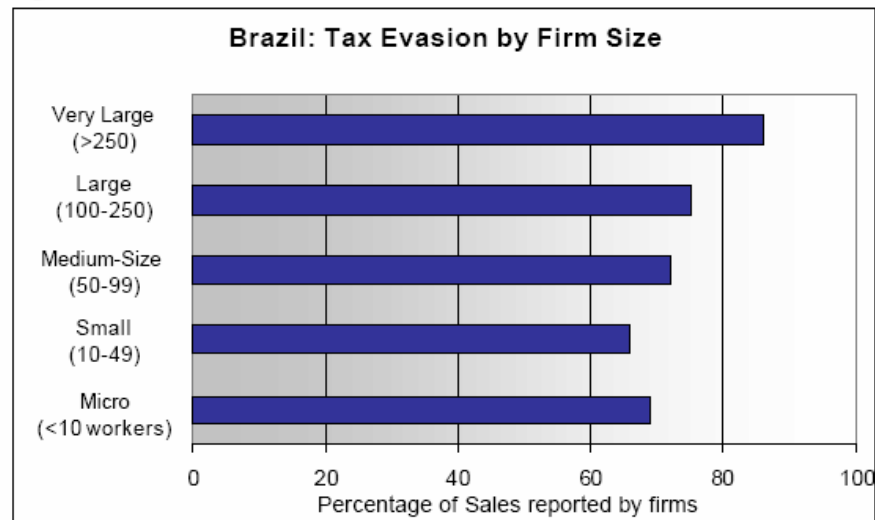
Informality measured by Social Security Contributions decreases rapidly with firm size

Firm size	Share of firms workers that are informal		Distribution of informal workers	
	México	Brazil	México	Brazil
1-2	97%	89%	35%	34%
3-5	90%	66%	42%	275
6-10	50%	44%	7%	14%
11+		18%		25%
11-15	39%		3%	100%
16-50	26%		6%	
51-100	14%		2%	
101-250	12%		1%	
+250	7%		6%	

Informality and Size

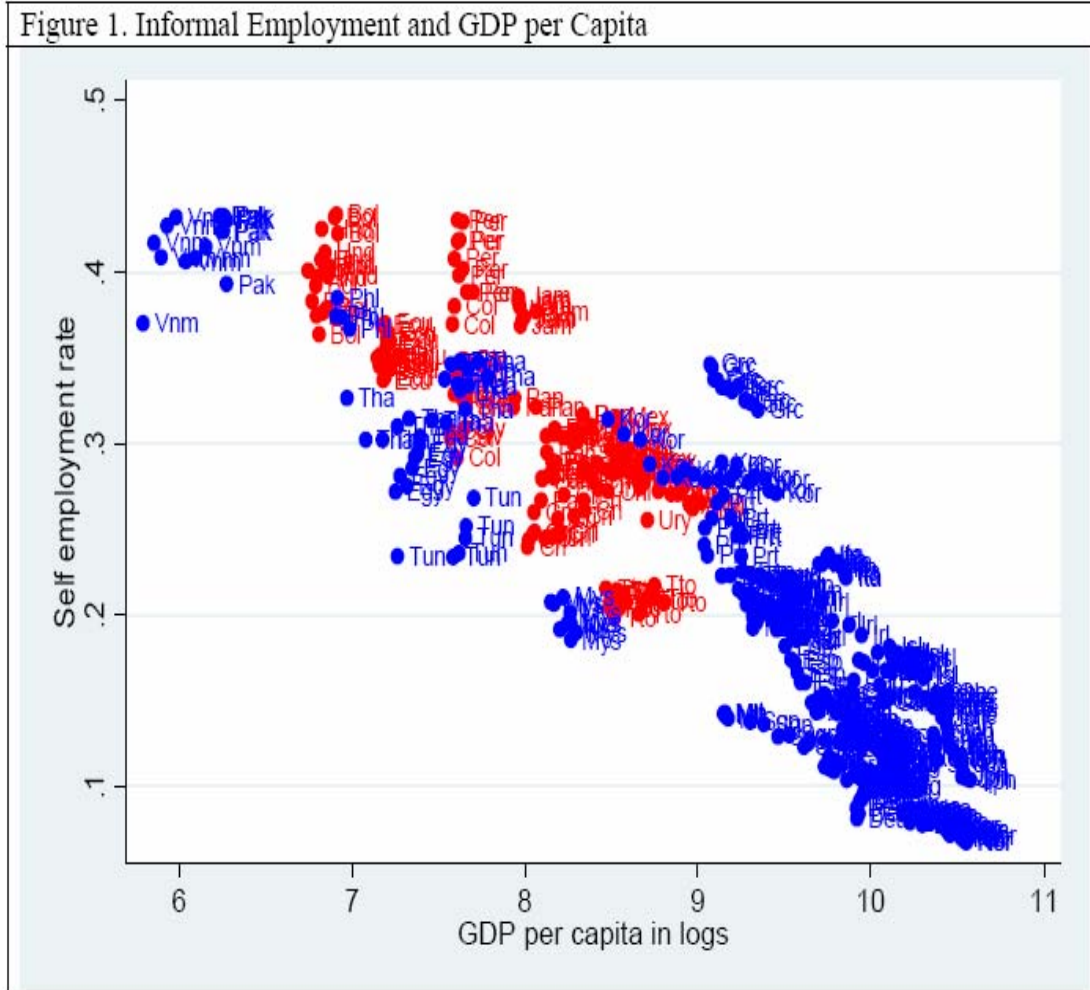
Tax evasion reduces only slightly with firm size

Figure 2:



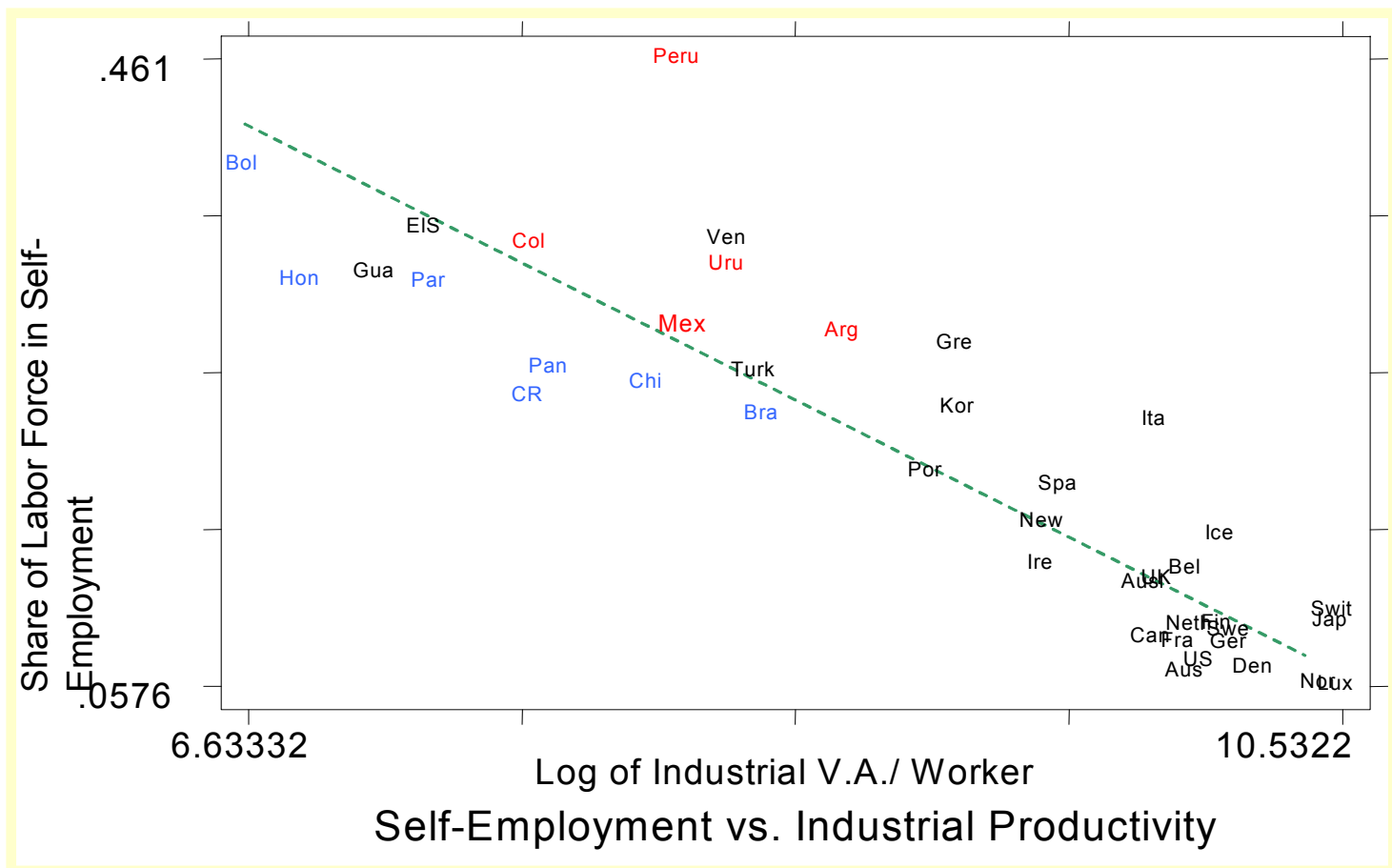
Regrettably, Brazilian labor surveys allow only limited tabulation of the share of “workers without protections” by size, but the Mexican employment survey permit finer disaggregation (Table 1). As we see, even medium and large firms above 50 workers

Informality is mostly an issue of Development level



Informality is mostly an issue of low productivity

Self Employment vs. Formal Sector Productivity



Is Informality always countercyclical?

- Dualistic view seem to hold in recessions (*relative size of informal sector increases and wages decrease*), but not necessarily in booms (Gasparini et al, 2006)
- Informality is highly sector dependent (*rural, construction and commerce*)
- Trend in informality in booms depends on the origin of the shocks (+) (Fiess, Fugazza & Maloney, 2006):
 - Tradable sectors: **both** relative size **and** wages of formal sector **both increase**
 - Non tradable sectors: **both** relative size **and** wages of informal sector **increase**
 - Close relation between REER and informality
- And on the importance of formal sector downward wage rigidities, which become more binding *and lead to less formal job gross creation flows* in recessions (Bosch & Maloney, 2006)

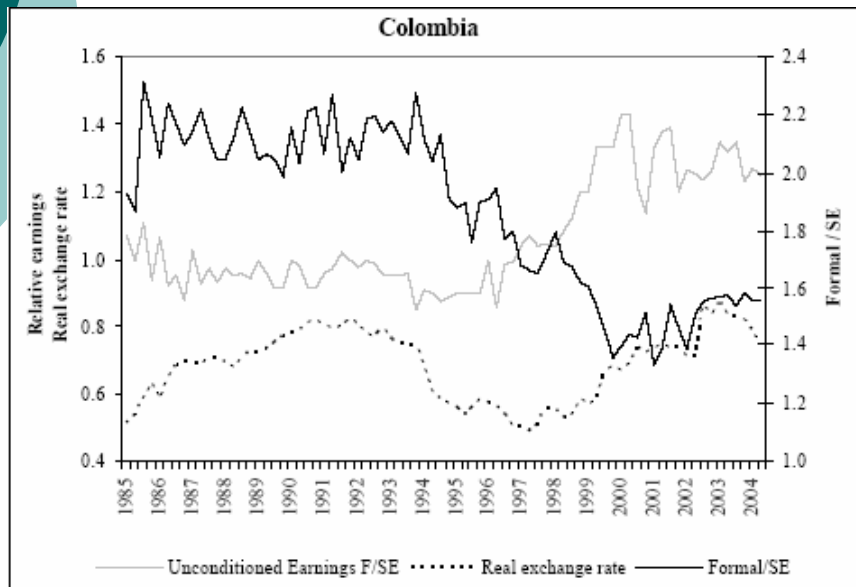
Is Informality always countercyclical?

(Fiess, Fugazza & Maloney -2006-)

- Periods booms, REER appreciation and increases in relative size and wages of informality
 - Argentina: 90/94
 - Brazil: 93/96
 - Colombia: 92/96
 - Mexico: 87/93
- Recent periods with negative correlation between relative size and wages of informality:
 - Argentina: after 00 (recession and crisis)
 - Brazil: 99/00 (slowdown)
 - Colombia: 98/02 (recession)
 - Mexico: none

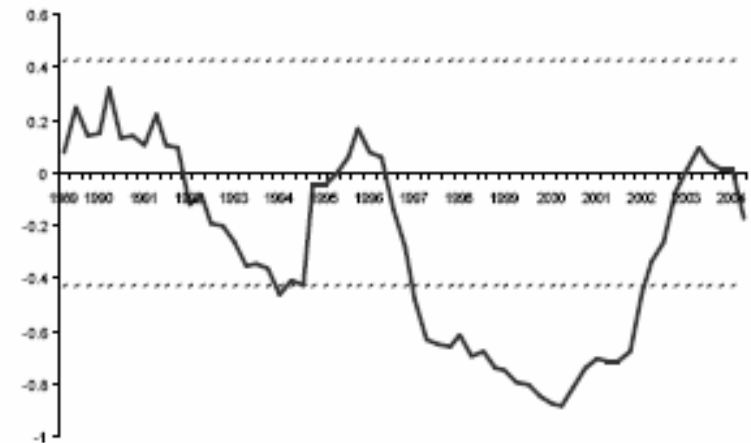
Is Informality always countercyclical? The Colombian Case

Relative Sector Shares and Earnings,
Real Exchange Rate



Rolling Correlation between
relative sector size and relative wages

Colombia



Note: 16 period rolling window, dashed lines represent 10% level of significance (0.426). Values above (below) 0.426 (-0.426) indicate significant positive (negative) comovement of relative sector size and relative wages

Consequences of “excess” informality

- Lower productivity and growth of *some* small firms at the *margin* of formality
- Lower creation of formal employment, specially in periods of low growth
- Welfare, fiscal (*contingent liabilities*) and efficiency implications (*health, education, adoption of technologies*) of excessive exposure to risks by informal workers and small firms.
- Lower (*VAT and income*) tax productivity, leading either to high rates and distortionary taxes (*eg, Brazil*) or low supply of public goods and services (*most other LAC countries*)

*Direct conditional growth effect of informality appear to be small (Rigolini,2006), but **determinants** of low growth and high informality have substantial overlap*

Determinants of “excess” informality

- Business Regulation:
 - Observed (One-shot?) increases in registration when cost and time are reduced
- Labor taxes and regulation:
 - Significant effects in most countries during recessions (Fiess, Fugazza & Maloney -2006-), but probably also a secular increase (Bosch, Goni and Maloney -2006-)
- Social Protection:
 - High and rigid contributions in SS (low benefit/cost ratios for many) appear to have an important effect (Gill and Packard, 2004)
 - Social assistance without SS reform may increase informality further (Levy, 2006)
- Taxes: (Alms and Martinez, 2006)
 - High marginal rates induce evasion, *ceteris paribus*
 - But evasion (*and tax collections*) is mostly related to economic structure, political/enforcement issues and tax culture
 - Tax fairness (in law and enforcement), tax facilitation and good provision of public services reinforce tax culture

Estimation of effects of a pure tax on labor on the size of the Informal Sector

	Approach	Semi-elasticity	Effect of 30% pure tax on size of SE sector
Maloney (1998), Loayza and Rigolini (2006)	Cross sectional estimation	.03-.052	.9-1.5%
Krebs and Maloney (1998)	Simulation from transitions	.3	9%

Is “excess” informality –and low growth– a multiple equilibrium problem?

- Good social contracts: rule of law and high enforcement; good investment climate; flexible labor markets; efficient, productive and equitable taxation, public services and social protection<> high growth and low informality
- Bad social contracts: the opposite
- If so, how to shift from “bad” to “good” equilibriums?
 - An important improvement in few dimensions (*eg: governance*) may lead to a change in equilibrium?

Is “excess” informality –and low growth- a multiple equilibrium problem?

- Initial conditions: high inequality has led to a truncated and inefficient welfare State:
 - Low skills for a large proportion of workers
 - Excess benefits for some –elites, government employees, organized labor- and low benefits for most;
 - Distorted and inefficient taxation;
 - Low legitimacy of the State and, hence, poor law and order, low enforcement and poor investment climate.
- Globalization and democracy pressures for change?
- A matter of time plus political leadership?



THE END