

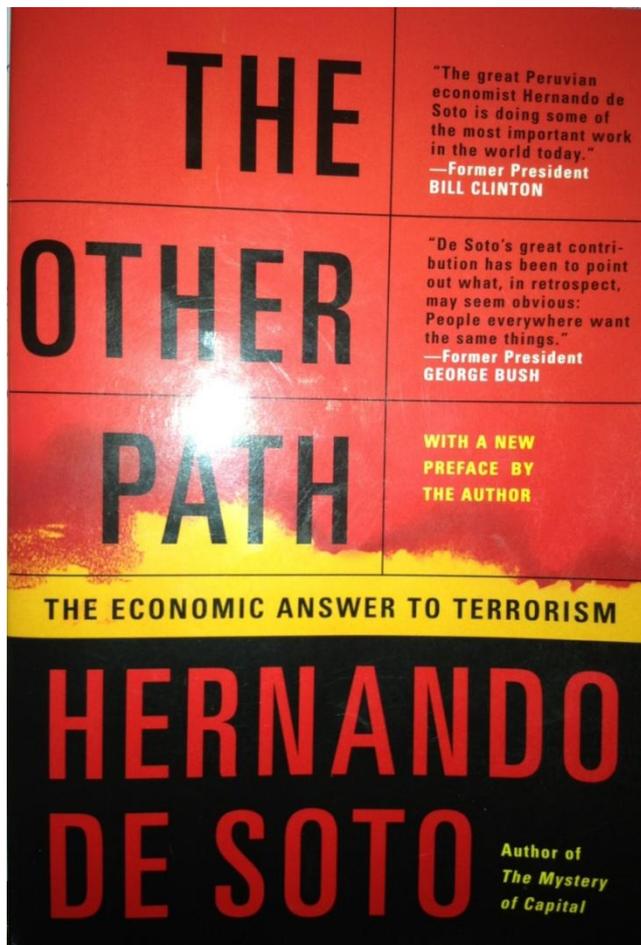
# What should we do about informal firms?

## *Why de Soto is half-wrong and the IRS half-right*

David McKenzie, DECFP

July 9, 2013





- “Informals have very similar aspirations to formals”
- “We **know** that the costs of informality, including more expensive capital and the absence of facilitating legal instruments, generally result in lowered productivity.”
- “What can we do to prevent informal energies from being kept in check by a punitive legal system...the **answer is to change our legal institutions in order to lower the cost of producing**”

Article | *McKinsey Quarterly*

# The hidden dangers of the informal economy

July 2004 | by Diana Farrell

- “informal companies persistently drag down a country's overall productivity and standard of living”
- “In Portugal and Turkey, informality accounts for nearly 50 percent of the overall productivity gap with the US”

# The ILO

“When a large part of the working population is found in the informal economy, with low incomes and few possibilities to save, poverty cycles are perpetuated”

“the formalization of informal employment will be **the fundamental strategic objective of the ILO** in Latin America and the Caribbean in the upcoming years”

Elizabeth Tinoco, Regional Director of the ILO

June 11, 2013

# What does the World Bank say?

- **Doing Business 2013** “Informality comes at a cost. Compared with their formal sector counterparts, firms in the informal sector typically grow more slowly, have poorer access to credit and employ fewer workers”.
- **WDR 2013** “Whether informality is the result of exit, exclusion, uneven enforcement, or low firm productivity is still a matter of debate.” “the use of public services by the informal sector, without proper tax contributions, puts a burden on formal firms and lowers their productivity as well”.

# A decade of Doing Business Reforms

- 368 reforms took place in 149 economies between 2003 and 2012.
- world average time to start a business has fallen from 50 days to 30
- cost of starting a business is one-third of what it was



But despite these reforms, informal sector still large in most developing countries.

# Outline

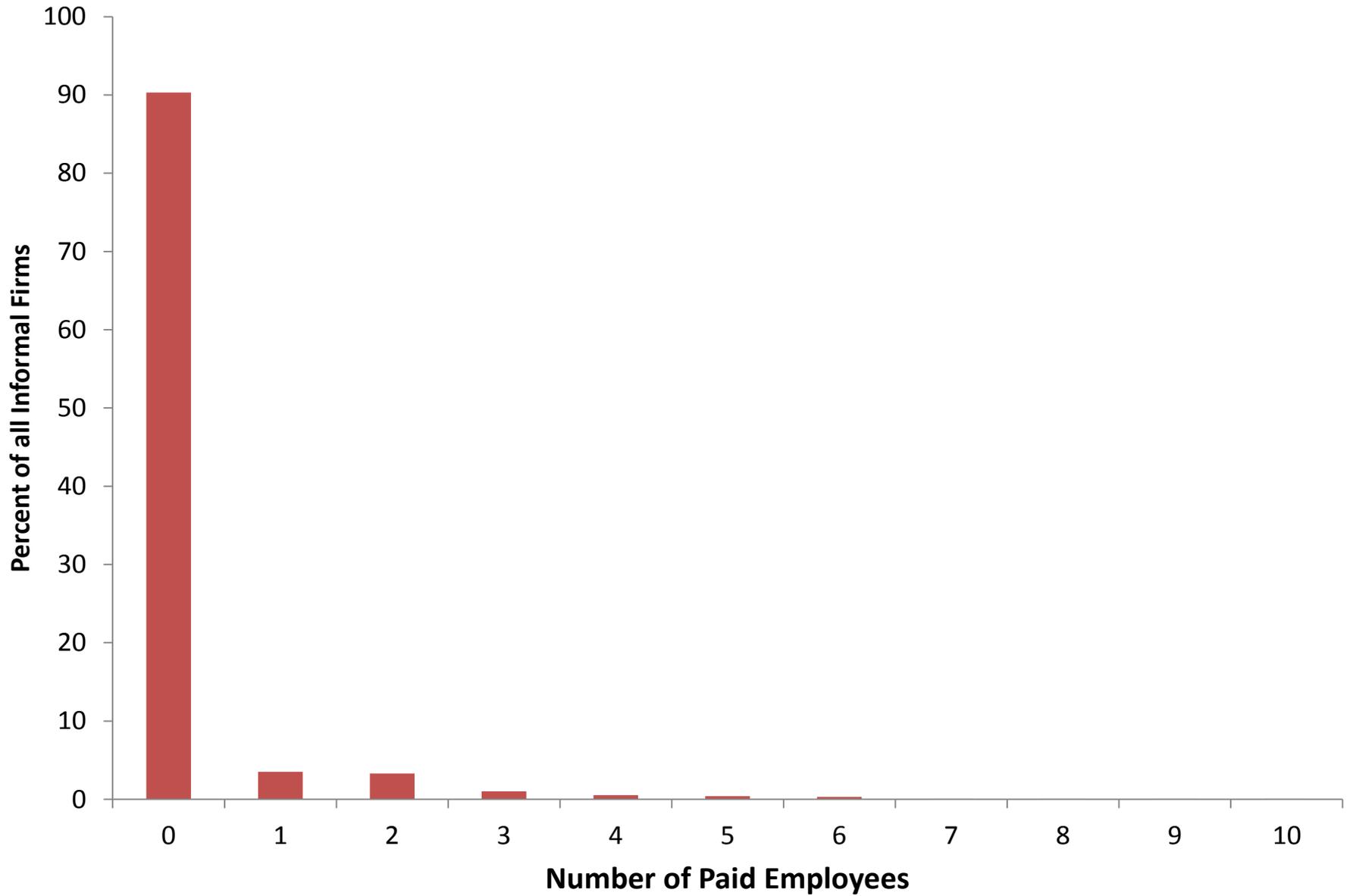
- What do we mean by informal firms?
- How much can we expect from making it easier for them to become formal?
  - Regulatory simplification
  - Information campaigns
- Does it benefit informal firms to become formal?
- If not, why might we want to formalize them?
- A little more stick? Enforcement as part of the solution
- So what should we do about informal firms?

What do we mean by informal  
firms?

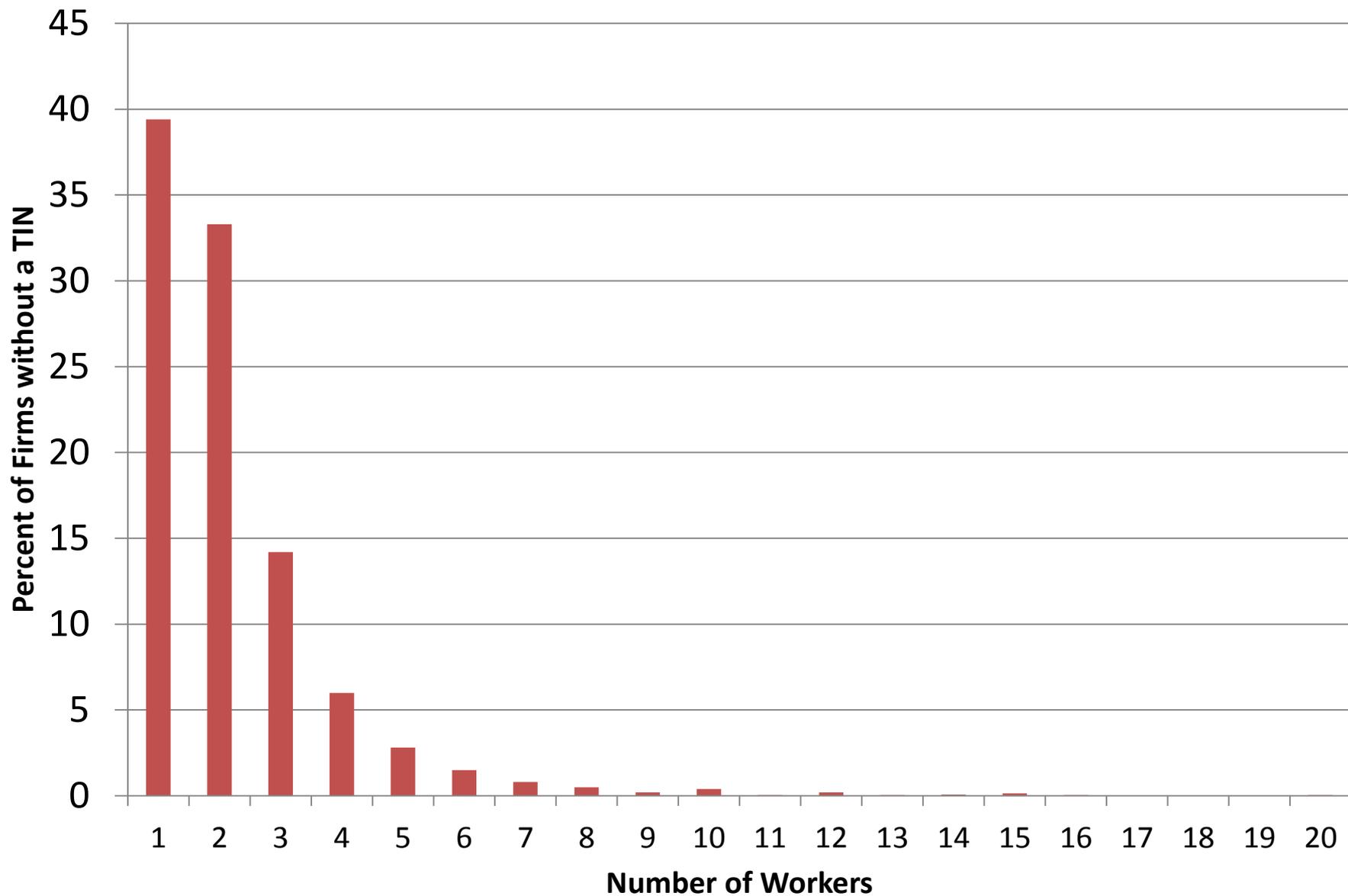
**Formal** = registered with the  
government

- different levels – tax registration,  
municipal registration, VAT  
registration, labor registration, etc.  
(can also talk about share of income  
actually reported for tax purposes)

## Size distribution of Informal Sector in Sri Lanka

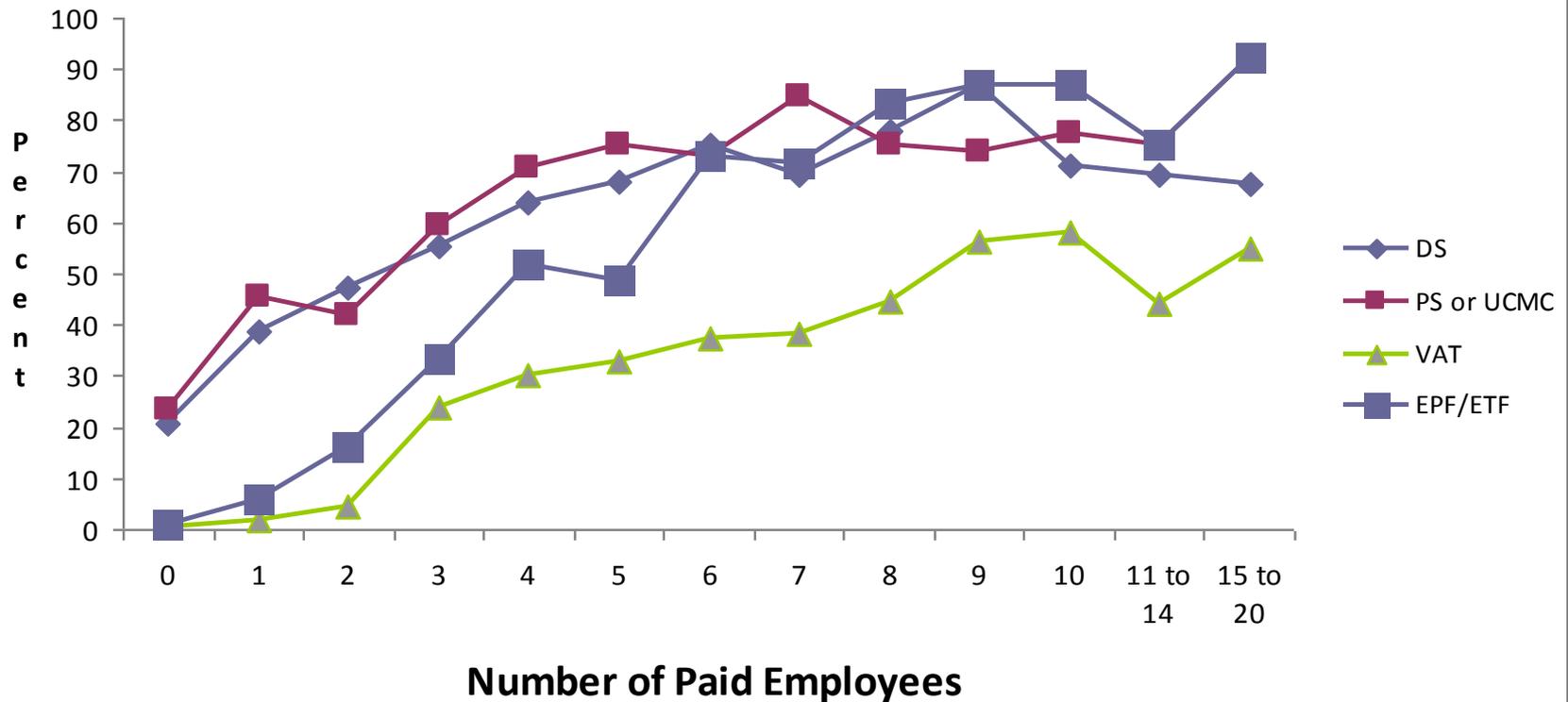


## Size Distribution of Informal Firms in Bangladesh with 1+ workers



# By 10 workers, most firms have formalized

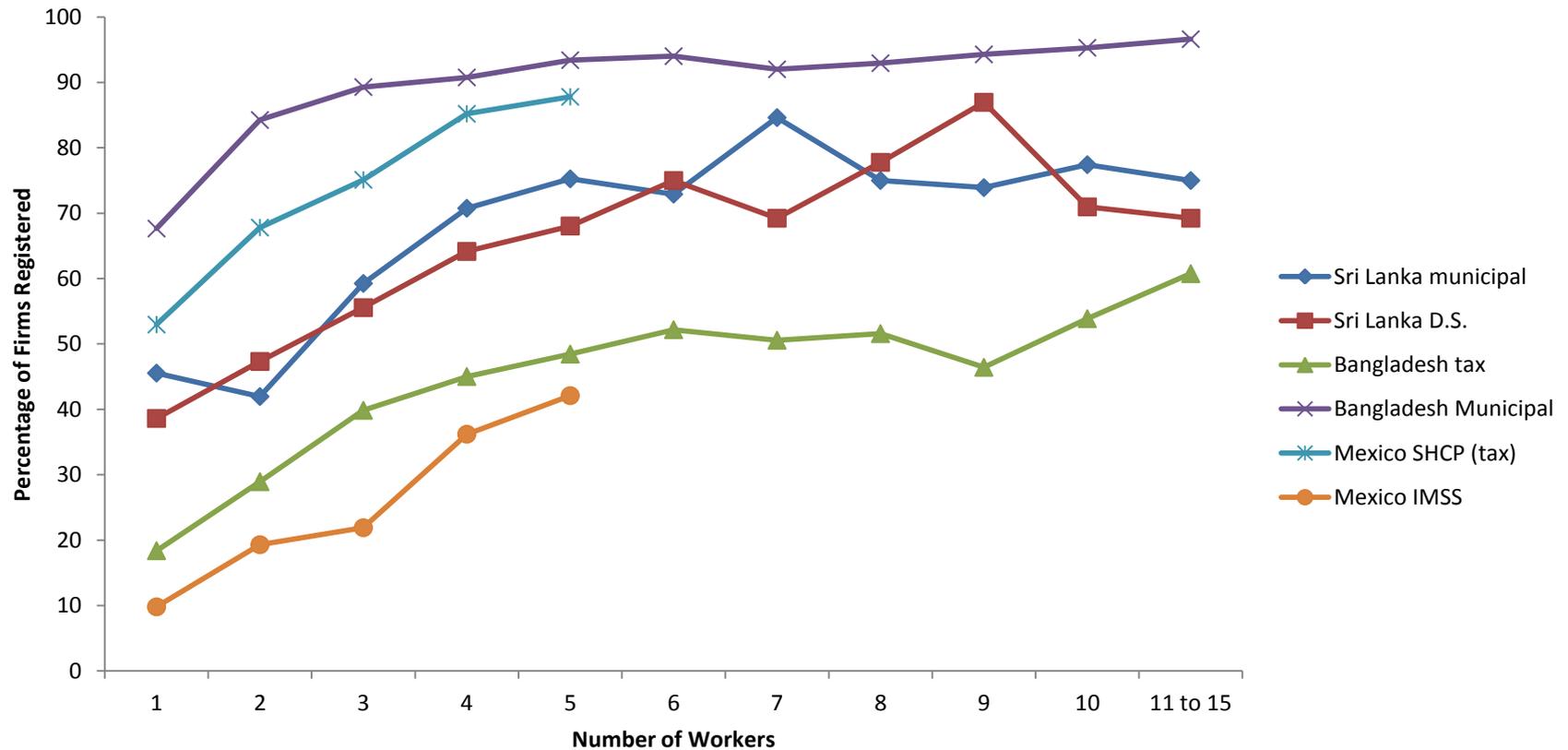
**Figure 1: Percentage of Firms Registered with different Government Entities by Firm Size**



Source: SLLSE

# Similar in a number of countries

Figure 2: Formality against Firm Size in Different Countries



# Measuring the wrong thing when it comes to formalization of informal firms

- **Doing Business** measures the ease of starting a business for a company with start-up capital of 10 times per capita income, turnover of at least 100 times per capita income, and between 10 and 50 employees
  - i.e. for a firm in about 99.5<sup>th</sup> percentile or higher of firm size distribution!
  - Presumably a correlation between registering a **company** and registering a small business as a sole proprietor – but not clear how high.

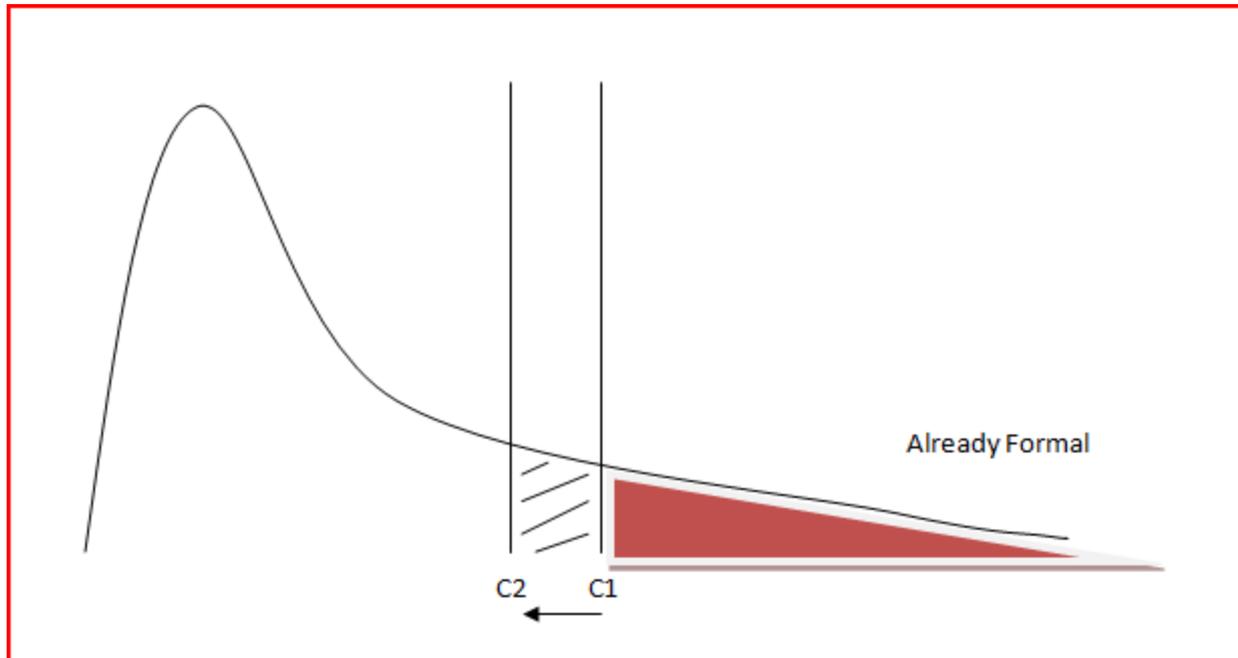
How much can we expect from  
making it easier for informal firms to  
become formal?

# Effect of Lowering Costs of Becoming Formal

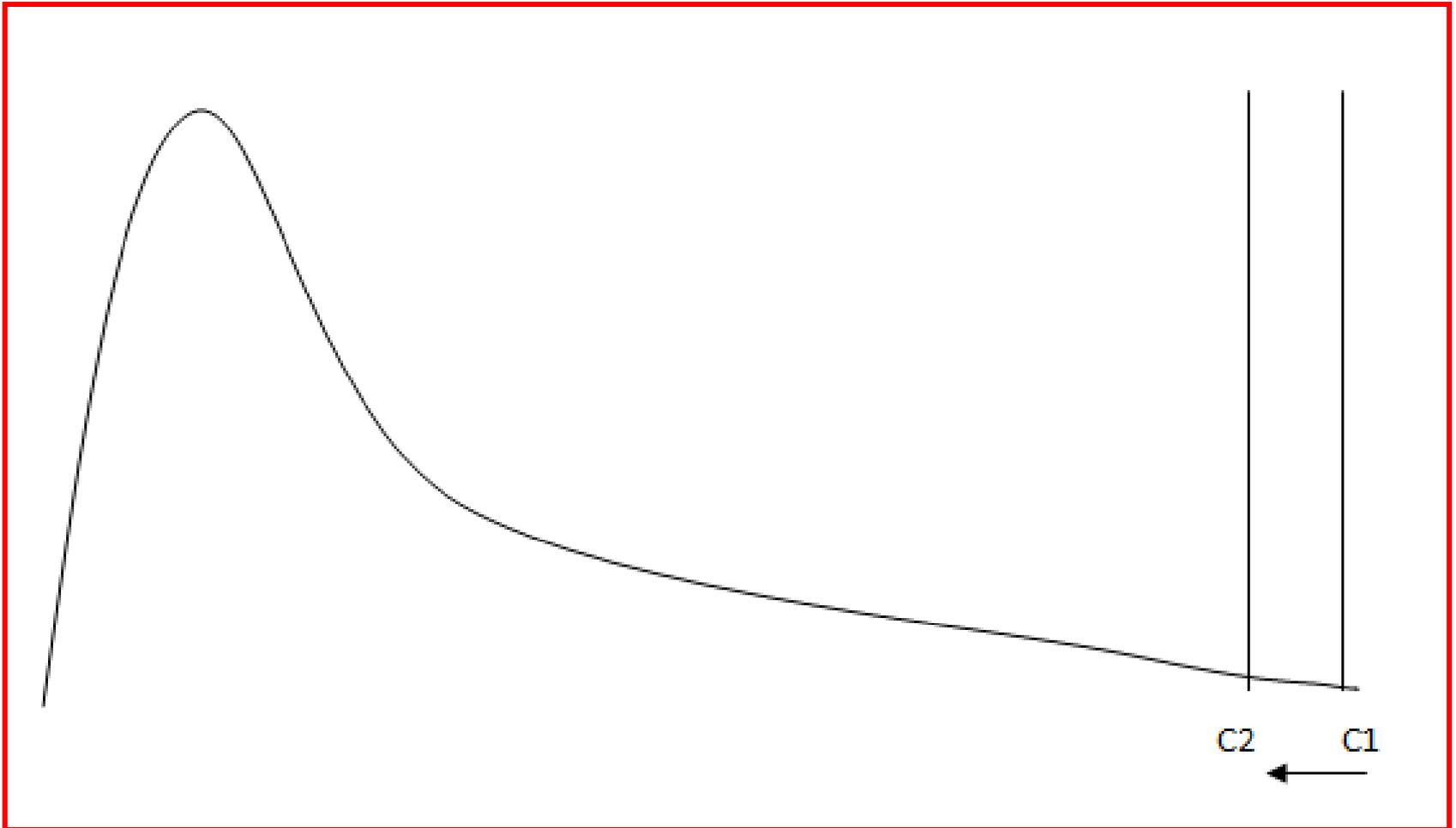
Formalize if

$$\underbrace{\sum_{t=1}^T \beta \delta^t EU(\pi_{F,t} - \pi_{I,t})}_{\text{Net Benefit from Formalizing}} > \underbrace{C_{\text{Money}} + C_{\text{Time}} + C_{\text{Information}} + \lambda_{\text{liquidity}}}_{\text{Net Costs}}$$

Net Benefit from Formalizing  $>$  Net Costs



In practice few firms may be close to this margin of wanting to formalize



# Evidence:

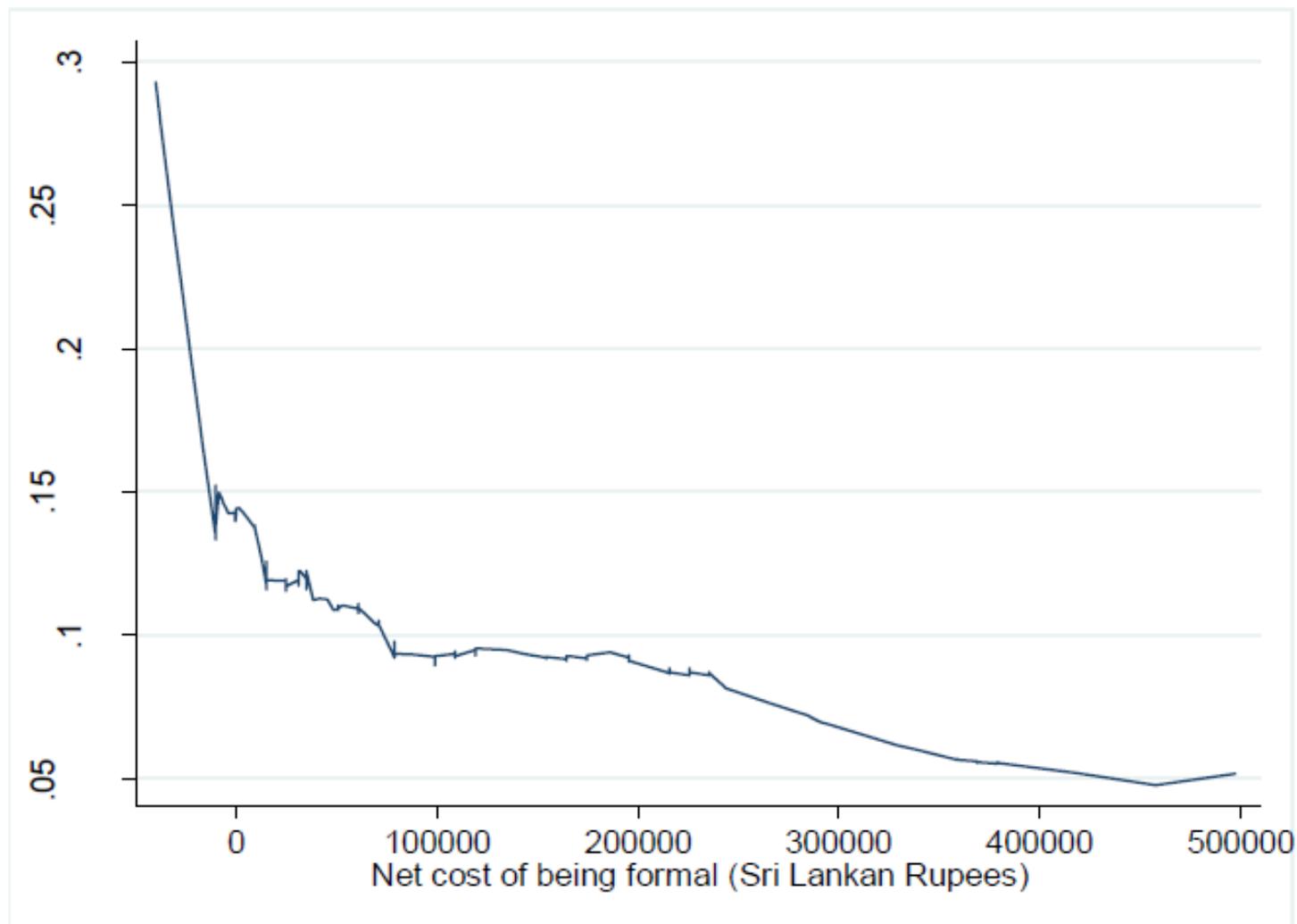
- **Big picture level:** Brazil simplified tax system, introduced one-stop shop, but after all this, still find 72% of all firms to be informal in Minas Gerais.
  - **Evidence from Regulatory reforms:**
    - Mexico: Bruhn (2011, 2013) – overall increase in business registrations of 5% from large reform; only small number of existing informals formalize.
    - Peru: Mullainathan and Schnabl (2010) – increase in provisional municipal licenses, but many don't renew.
- => Few firms are in range where *monetary and time costs* are key barrier to whether formalize or not.

# Evidence: information costs?

- Many informal firms not well informed about costs and process of becoming formal; often overestimate both time and cost.
- But doesn't mean we need information campaigns.
- RCTs of information campaigns:
  - De Mel et al. (2013) – Sri Lanka – zero effect on tax registration
  - Andrade et al. (2013) – Brazil – zero effect on tax registration
  - De Giorgi and Rahman (2013) – Bangladesh – zero effect on registration.
- Some larger effects on **municipal** registration when information + cost subsidy
  - Lima - Alcázar et al. (2010) - 10-12% register
  - Malawi – early results show 70% + registration when you basically do entire process for them.

# The demand for formalization

Figure 1: The Demand for Formality in Sri Lankan Firms as a Function of the Net Cost of Formalizing

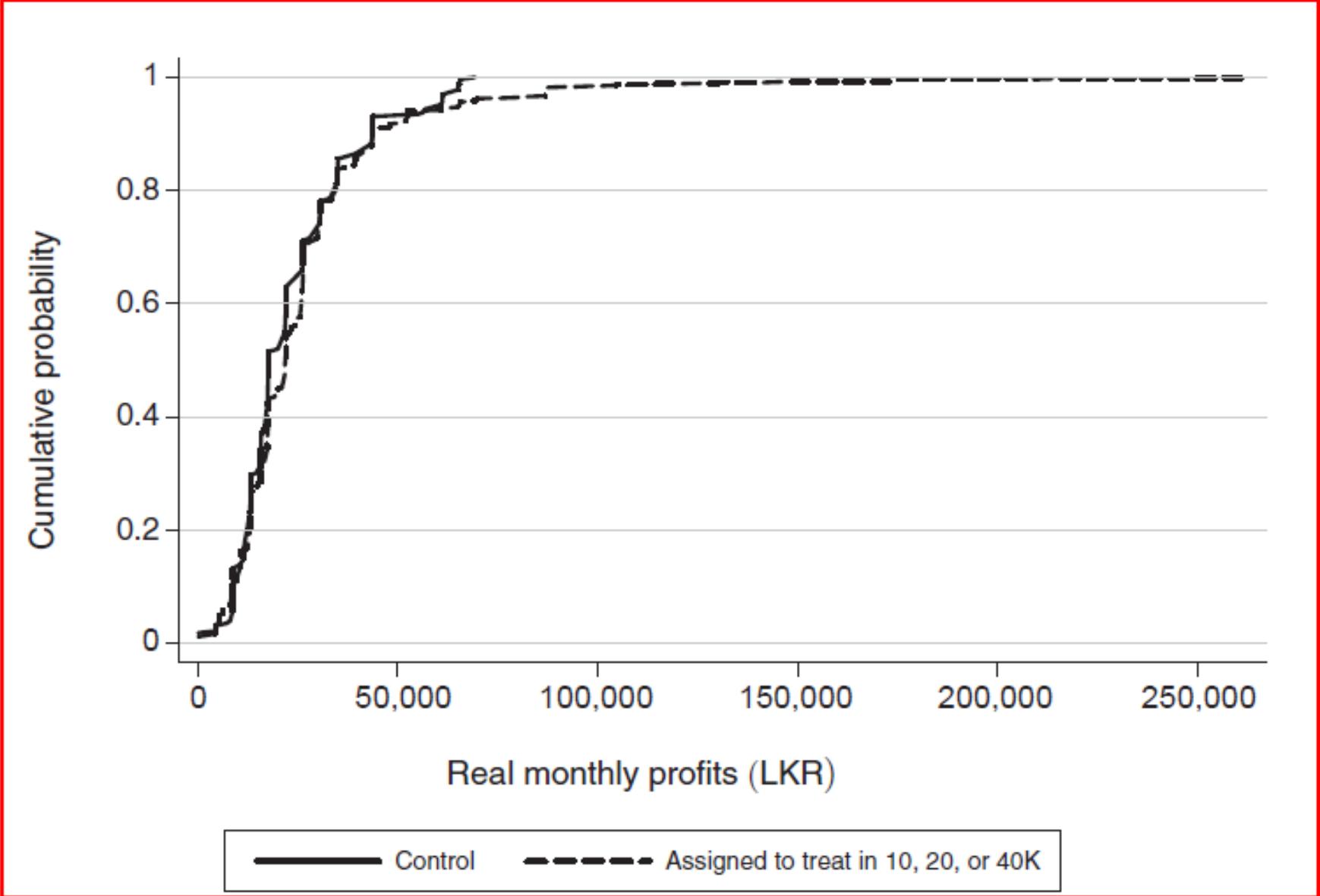


Does it benefit informal firms to become formal?

# Claimed and actual benefits of being formal

- *Informals have to operate in the shadows, can't be too big or visible.*
  - **True:** Bolivia (McKenzie and Sakho), Brazil (Fajnzylber et al), Sri Lanka (de Mel et al.) – more advertising, more permanent locations.
- *Formalizing helps firms get access to finance*
  - **False:** no greater access to finance in Bolivia, Sri Lanka.
- *Formalizing helps firms through the ability to sell to the government, and participate in government programs*
  - **False:** empirically informal firms that formalize no more likely to do this than similar firms remaining informal.

# Overall impact: zero for most firms, a few firms benefit



If it is privately rational for firms to be informal, why might we want to formalize them?

# Claims about broader societal impacts

- Claim 1:** Most developing countries need to widen their tax base - public rationale for collecting taxes from relatively well-off owners of informal firms & revenue collected from them will be sufficient to justify the costs of formalizing them
- Claim 2:** informality leads to inefficient resource allocation, since informal firms who don't pay taxes can compete away customers from more efficient tax-paying formal firms
- Claim 3:** “broken-windows” theory - presence of so many informal firms may send a message to the public that obeying the law is optional, and also dissuade more prosperous informal firms from formalizing

A little more stick? Enforcement as  
part of the solution  
(or why the IRS is half-right)



## IRS Audits Keep Companies Honest, Says Research

- *Direct effect* – companies receiving audit end up paying more tax when mistakes uncovered
- *Indirect effect* - U.S. public firms undertake less aggressive tax positions when tax enforcement is stricter – fear of audit changes behavior.

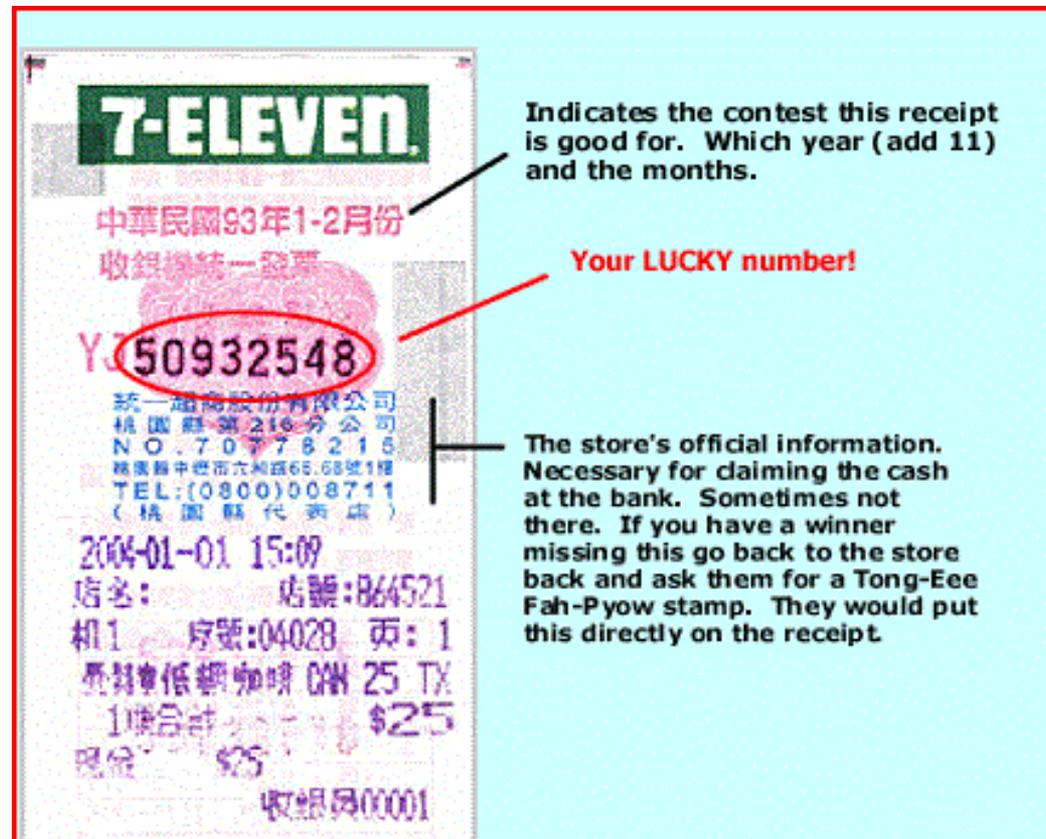
# Does it work with informal firms?

- Brazil experiment – randomly assigned municipal inspectors to visit firms (targeted larger informals)
  - In some cases couldn't find firms; others firms were already formal
  - Impact of an additional inspector visit was a 22-27 percentage point increase in likelihood firm gets municipal license.
  - No change in likelihood firm shuts down.
  - However no spillover effects onto neighboring firms
  - Appears cost-effective in terms of cost of inspection vs taxes would raise from it – but question of who pays for inspectors vs who receives tax revenue.

# Enforcement need not just be about inspectors...

- Tax invoice lottery – Taiwan, Korea, China, Puerto Rico

17% increase in sales tax revenue from introducing this in China



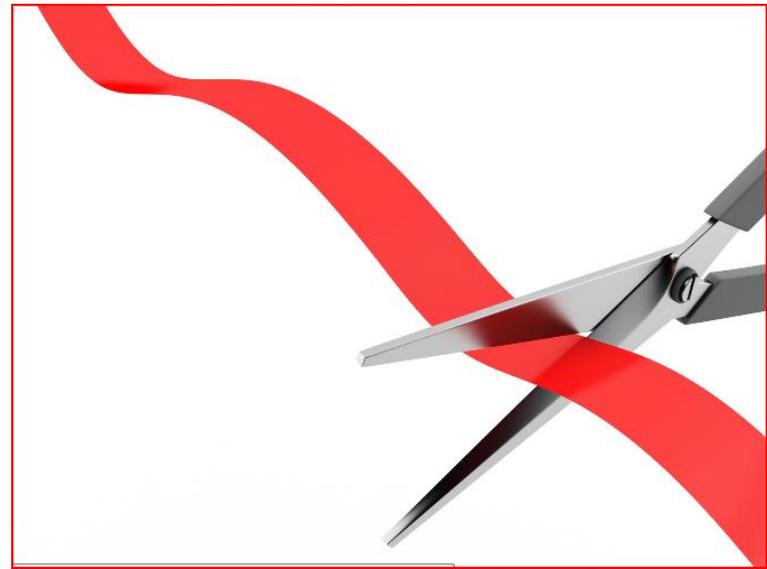
So what should we do about  
informal firms?

# Firms are mostly optimizing

- Existing evidence suggests most of these firms are making what is a privately optimal decision, and so the policy rationale for trying to bring small scale informal firms into the formal sector should not rely on the belief that doing so will bring benefits to these firms

# Stupid laws are still good to make better

- does not mean that there is no cost to inefficient and costly regulations – making firm owners spend extra time and hassle in registering their firms is usually a pure social cost, and so efforts to simplify regulations will benefit those who choose to go through this process



# Larger and more profitable informal firms

- Even under progressive income tax system, probably want to raise taxes from e.g. people with businesses with \$1000/month income
  - Revenue raised from them likely to more than offset costs of enforcement
  - Most likely to be firms competing with/undercutting formal firms
- => Seems to be public rationale to formalize these types of firms

# Larger and more profitable informal firms

- Lowering cost and complexity of registration and compliance only part of the solution
  - Need to increase enforcement of the simplified rules
- + experiment with novel incentives for others to bring them into the system (e.g. tax receipt lotteries)

# Subsistence informal firms

- Firms likely to see no benefits from formalizing
- Under progressive income tax system, also likely to contribute little to tax revenue if they do
- May still compete with larger formal firms, but perhaps not very well – and government may prefer to leave them alone than shut them down.

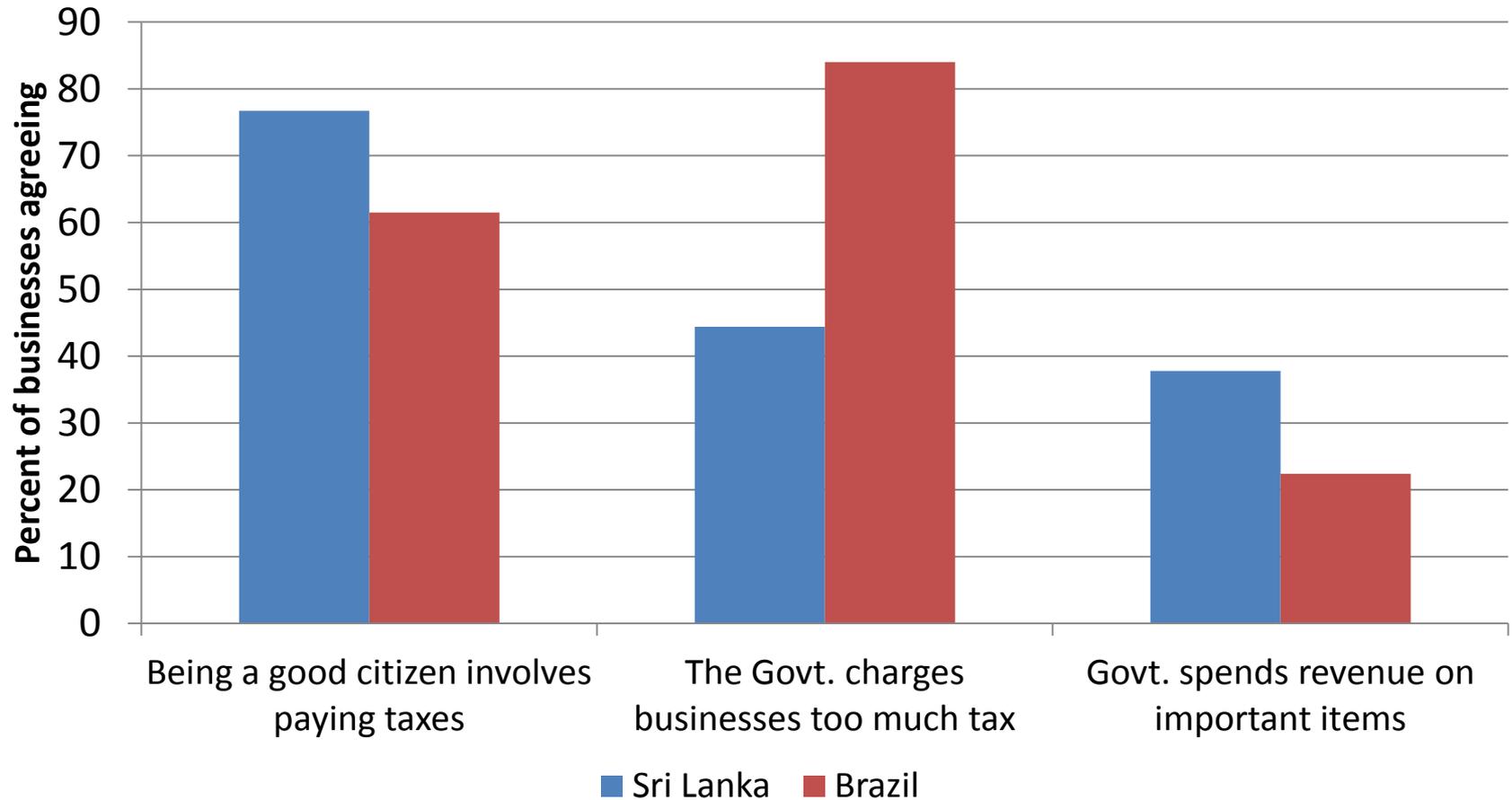
**But...**



# Write sensible laws...

- Write law in such a way that subsistence firms find it easy to comply
  - In low capacity states, perhaps make them not need to register.
  - Otherwise have them register easily and at low cost, and don't require income taxes from them until incomes exceed certain thresholds.

# ..and more directly link taxes to benefits



# Summary

- Why is de Soto half-wrong?
  - Not the case that most informals are desperate to become formal and only burdensome regulations prevent them
  - But is correct that regulations are often way too burdensome for those who do
- Why is the IRS half-right?
  - Enforcement of the laws crucial part of ability to finance the government – making it easy is by itself not enough
  - But enforcing complex and complicated laws creates burden and distrust