This month’s theme: INFORMALITY

New study reveals the causes of the informal sector and its links with economic growth

Two schools of thought have dominated discussions of informality. The first claims that informality is a consequence of a lack of development, and a failure to establish sufficient protections for workers. The second argues that it’s the result of bad governance—whether through excessive regulation or poor government services. In this talk, Norman Loayza focused on the trade-offs leading to informality that various social and economic agents face. Policy makers face a trade-off between taxation for the provision of public services and the possibility of tax evasion. Likewise, owners of firms face a trade-off between high relative costs of labor in the formal sector and high relative costs of capital in the informal sector. Informality arises both from a lack of development and poor governance, and each of them to a different extent for every country. For instance, when comparing Peru and Chile, regulatory burdens appear to be the main driver of higher informality in Peru. Comparing Indonesia and South Korea, however, the gap in terms of educational achievement seems to explain the higher informality in Indonesia. Loayza also presented a new study to understand informal labor, placing it in the process of development, allowing for its heterogeneity, and linking it to migration, modernization, and economic growth. Based on this study, Loayza announced a new tool that will estimate the size of the informal sector in nearly 100 countries over the next two decades based on a range of scenarios and parameters. These projections will hopefully guide policy makers in developing reform programs that will reduce informality, and support the creativity of small-scale entrepreneurs while allowing firms and the whole economy to grow.¹

Testing incentives to formalize firms in Benin

In 2009, the Benin national statistics agency estimated the informal sector at 70 percent of GDP and 95 percent of employment. In April 2014, the Government launched the entreprenant status, a simplified and free legal regime offered to small informal businesses to enter the formal economy. A randomized impact evaluation tested three versions of the entreprenant status on business registration decisions. The first version tested whether simplifying entry regulation and providing information alone could be effective. The second version tested the notion that businesses may need additional incentives to formalize and additional support to access benefits and grow. In the third version businesses received tax mediation services as an additional incentive to formalize. The study randomly allocated 3,600 informal businesses operating in Cotonou, Benin to the three treatment groups and one control group. After one year,

¹ Event | Story | Video | Presentation | Policy Research Working Paper 7858 | Toolkit for Informality Scenario Analysis

http://econ.worldbank.org/research
formalization rates rose in all three groups: 9.1 percentage points in the first treatment group; 13 percentage points in the second treatment group; and 15.8 percentage points in the third treatment group. The program had a higher impact on male business owners, those with more education, operating outside Dantokpa Market (the biggest informal market), in sectors other than trade, and that had characteristics similar to already formalized businesses.²

Incentives to formalize firms in Malawi that worked
Informality remains extremely high among firms in Sub-Saharan Africa despite efforts to make formalization easy. In most of the region, business registration in a national registry is a separate process from tax registration. In Malawi 93 percent of firms have not registered with the government. An experiment to encourage formalization involved randomly allocating firms to a control group and three treatment groups: Group 1 was offered assistance for costless business registration; Group 2 was offered assistance with costless business registration and (separate) tax registration; and Group 3 was offered assistance for costless business registration along with an information session at a bank that ended with the offer of business bank accounts. All three treatments boosted business registration, with 75 percent of those offered assistance receiving a business registration certificate. Information and assistance had a limited impact on tax registration, which is consistent with other studies. Measures of the short-term impacts of formalization on financial access and usage showed business registration alone has no impact for either men or women on bank account usage, savings, or credit. However, the combination of formalization assistance and the bank information session resulted in significant impacts on obtaining a business bank account, financial practices, savings, and use of complementary financial products.³

A tax regime aimed at micro businesses increased formal business registration only in the first year in Georgia
Tax policy and administration is an important instrument affecting businesses’ formalization decisions and their related growth potential, as well as the relationship between governments and their constituents, particularly in developing economies. This research examines the introduction of preferential tax regimes in Georgia for micro and small businesses in 2010, and how it affected formal firm creation and tax compliance. The new tax regime for micro businesses increased the number of newly registered formal firms by 18-30 percent below the eligibility threshold during the first year of the reform, but not in subsequent years. Overall there is no effect of the new tax regime for small businesses on formal firm creation in any year. Policy makers are often concerned about abuse risks stemming from differentiated tax treatment of micro and small businesses. This analysis reveals reduced tax compliance in 2010 around the

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micro business eligibility threshold, but does not find significant evidence of reduced compliance by Georgian firms in later years.\textsuperscript{4}

**Mandatory pension contributions encourage informality in Chile**

One-third of legal economic activities are concealed from public authorities to avoid paying taxes and social security contributions, and to elude regulation. Large informal economies pose formidable challenges for pension systems. Higher informality rates lower pension contributions and tax revenue and may increase the elderly’s reliance on costly safety nets. At the same time, mandatory pension contributions and retirement income transfers can themselves create incentives for workers to avoid formal employment, making it hard to reconcile old-age poverty reduction and budget balancing. These fiscal and welfare trade-offs are assessed using a life-cycle model of labor supply and saving decisions in which household preferences and earnings opportunities in the formal and informal sectors are estimated from data on Chilean households. The analysis finds limited support for formal jobs rationing. Instead, mandatory pension contributions do significantly encourage informality. Policy experiments show that Chile could lower pension spending by 23 percent—while guaranteeing the same minimum income to retirees—by choosing a higher minimum pension clawback rate (the rate at which the non-contributory government-funded pension is reduced as an individual’s contributory pension increases). This is because the clawback rate does not strongly impact the decision to work formally and contribute to the pension system.\textsuperscript{5}

**Testing the evaluations of programs to formalize firms in Brazil**

Most evaluations of programs to help informal firms formalize conclude they do not work. One of the few exceptions is a study that shows large effects of a tax simplification program in Brazil called SIMPLES. Another study using the same dataset but a different identification strategy, concludes that the program had a limited effect on formalization rates. This work reconciles the conflicting conclusions and investigates the plausibility of the identification strategy used in both studies. It turns out the conflicting results are caused by the dates used to identify when the program was put into effect. Further analysis suggests that “data heaping” and seasonality around November in the microdata cast doubts on the identification strategy used in both studies.\textsuperscript{6}

