

Sticks Rather than Carrots to Induce More Formality

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About the author

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In a nutshell

- Formalizing informal firms and employment has a number of potential benefits for the government, firms, workers, the economy and society.
- These include: increased tax revenue; more efficient reallocation of resources; increased output and income for firms and the economy; decent working conditions for workers; orderly work and business environments; and improved morality for society.
- Reforms to encourage firms to register and formalize can come in the form of both inducements such as better information and lower costs (carrots) and legal enforcement (sticks).
- Research shows that better enforcement policies, inspection and fines may have a larger impact than reducing the costs of registration, simplifying the rules and regulations and disseminating information on registration procedures. However, the two are not mutually exclusive.
- Policymakers should use an integrated strategy to bring informal workers and entrepreneurs into formal channels of protection, support and responsibilities with registration, while preserving their resilience and dynamic potentials
- Wider development and growth policies are important to help firms and workers move into the formal economy. They should also include skills training programs for upgrading skills of workers and entrepreneurs, microfinance and reforms for extension of social security coverage.

Formalization has many potential benefits for the government, firms, workers, the economy and society. Decisions by firms to move into the formal economy depend on their cost/benefit calculations. Using legal enforcement, inspections and fines may be more effective at getting firms and workers to move into the formal economy than making it easier and

cheaper to register; but they are not mutually exclusive, and policymakers should use an integrated approach. Policymakers should follow development policies such as upgrading skills, encouraging micro-finance and reform of social security coverage to encourage formalization.

Variety of informality

In the informal economy, the activities and the actors involved are diverse and operate in a wide range of sectors. Recent research has identified the vulnerabilities of workers and entrepreneurs as well as their buoyancy and dynamism. The actors are not officially recognized, are unrecorded, unprotected, unregulated and not registered in national statistics. They are outside the reach of social protection or labor legislation. They lack access to bank finance, technology and markets. In general they have low levels of skills, information, education, training and ability to manage risks and income. Workplaces may be unsafe and unhealthy. Productivity and incomes are usually low. Long hours of work are common. Productive resources such as land and property are limited. Firms in the informal economy include a wide range from marginalized and survivalist activities to profitable enterprises.

We differentiate between informality in employment and informality of firms. Informal employment refers to employment of workers without a contract or social security registration. Informal firms refer to firms or enterprises who are not registered and do not pay taxes. Firms choose whether to hire formal or informal workers and choose whether or not to register the firm.

Employment in the informal economy is counter-cyclical: it increases during times of crisis and contracts during times of high economic growth. The experience of Egypt during the 2000s is an example to the counter-cyclical behavior of the informal economy.

Size of informal employment in MENA

Indicators of informal employment are often based on non-agricultural activities. This enables better international comparisons since the relative size of agricultural employment varies between countries. However, in agricultural employment, lack of social security is a widespread phenomenon rendering much of agricultural employment informal. For instance, in Turkey, more than 90% of agricultural employment is informal.

In most regions of the developing world, informal employment makes up more than half of non-agricultural employment. For instance, it is 82% in South Asia, 66% in Sub-Saharan Africa, and 51% in Latin America (LAC). The lowest levels are observed in Eastern Europe and Central Asia with 10%. However, regional estimates may hide the diversity that may exist within a region across countries, For instance, in the Middle East and North Africa (MENA) the regional average for informal employment is 45% of non-agricultural employment. However, informal employment accounts for 31% of non-agricultural employment in Turkey, 52% in Egypt, 57% in Palestine, 46% in Algeria, 79% in Morocco, 49% in Iran, 52% in Lebanon, 31% in Syria, 51% in Yemen and 35% in Tunisia (Charmes, 2012).

The second most informal employment sector after agriculture is service activities. In MENA, they account for 31% of all non-agricultural informal employment. Outside of service activities, manufacturing accounts for 19%, construction for 26%, transportation for 10% and other services account for 17% of all non-agricultural informal employment. The construction and transportation sectors are male dominated branches of economic activity with very few informal women (Charmes, 2012).

MENA is the only region of the world where informal employment as a proportion of non-agricultural employment is significantly higher for men than for women. This is partly because there are more men in employment than women. This share is 35% for

women and 47% for men in MENA. In Sub-Saharan Africa, 74% of women and 61% of men are informally employed. In LAC the similar figures are 54% for women and 48% for men. In East and Southeast Asia women's and men's shares are nearly equal at around 65%. However, there is a large variation among countries in MENA. For instance, in Turkey the percentage of women in non-agricultural informal employment is larger than that of men.

In MENA the contribution of the informal sector, including agriculture to GDP, is about 36%. It is about 28% in Egypt, 42% in Tunisia, 36% in Iran, and 38% in Palestine.

Two views on informality

There are two views on informality. One group of economists believes that the informal sector is comprised of micro entrepreneurs who try to avoid the costs and responsibilities of formal registration. Onerous and complicated regulations and costs can drive firms underground. They argue that burdensome and time consuming regulations prevent firms from registering and thus becoming formal. Their informality results in lower productivity. They suggest removing burdensome regulations to increase formalization as suggested by international organizations, such as the World Bank. During the last decade, a number of countries followed this suggestion and introduced reforms making it easier to register a business or workers. For instance, in 1996, Brazil started a process of simplified firm registration, simplified tax systems and reduced tax burdens on small firms. Several studies that evaluated the results of such policies will be discussed below.

A more recent alternative view is proposed by neo-classical economists. They state that firms make a cost/benefit calculation in their decision on formalization just as in any other investment decision. According to this view, informality is a choice by entrepreneurs to avoid taxes and labor market regulations. The costs of formality may include initial registration

and ongoing costs such as tax payments. The benefits of being formal may include a reduced risk of being fined, the possibility of bank financing, and access to courts and government contracts and programs. If the benefits provided by formality outweigh the costs of being formal, then the decision will be to operate informally.

Benefits and costs of formalization

Formalization of both firms and employment is desirable. Several benefits of formalization are suggested in the literature. From the point of view of the government, formalization of firms widens the tax base and brings in additional tax revenue. High levels of informality mean lower tax collection, which restricts the government's ability to finance public services. From the point of view of the economy in general, formalization of firms allows more efficient reallocation of resources in the economy. Formal and informal firms competing in the same industry face different production costs, such as taxes and labor costs. Firms that formalize are shielded from inequitable competition from less efficient informal firms. Furthermore, formalized firms may benefit from government programs and bank financing possibilities and experience higher productivity and incomes. Formalization of employment brings in revenue to the government from social security premiums. Formalization of employment allows social security protection of health and retirement benefits for workers as well as sanitary and decent working conditions. From the point of view of the society at large, formalization may bring benefits, such as an orderly work and business environment, diminished culture of informality and corruption and increased morality and law-abiding social order. Costs for firms are the costs of registration and ongoing tax payments. Costs for the governments will include costs of information provision as well as enforcement.

Recent evidence on formalization policies

In the fight against informality, reducing the costs of formalizing is as important as increasing the costs of remaining informal. One way to raise the cost of remaining informal is to increase the enforcement of existing regulations. There is very little research on whether enforcement efforts can induce firms to register or close down and prevent firms from starting up. Evidence from developed countries shows that a higher likelihood of detection and enforcement leads to an increase in tax compliance. Other factors, such as a sense of moral or social obligation, are also found to be important. Similarly, evidence from developing countries also found that the degree of enforcement matters for labor informality (Almeida and Carneiro, 2012) as well as firm informality (Andrade et al., 2016). The former authors find that stricter enforcement in Brazil with an increase in labor inspections led to an increase in formal employment and a decrease in informal employment.

Brazil implemented a new system of tax exemption and simplification for tax collection for small and micro enterprises. Andrade et al., (2016) conducted a field experiment in Brazil to find out which government actions encouraged informal firms to register. They tested several competing mechanisms for reducing informality. These mechanisms included: providing information about how to register; coupling this information with an exemption in registration fees and free use of mandatory accounting services for a year; and visits by randomly assigned inspectors to firms to see whether increased enforcement would encourage firms to formalize. Their results indicated that the first two mechanisms resulted in increased knowledge about formalization processes but did not lead firms to formalize. In contrast, receiving a visit from an inspector did result in an increase in registration. In Egypt, labor laws adopted in April 2003 made it easier for employers to fire workers and allowed for fixed-term employment contracts that brought more flexibility in formal employment relations. Wahba and Assaad (2015) find that this brought a certain degree of formalization. De Mel et al., (2013) in Sri Lanka and De Giorgi and Rahman (2013) in Bangladesh found

no significant impact of information alone in getting firms to register.

Conclusion

Overall, these studies imply that providing information and reducing the costs of formalizing alone may not be enough to induce formalization, and should thus be coupled with enforcement. Firms that register face costs of paying taxes as well as keeping proper accounts. These costs may prevent informal firms from wanting to formalize unless they are forced to do so. Therefore, improving enforcement is an important tool to induce formalization.

However, these mechanisms should not be considered mutually exclusive, and implementing an appropriate combination of them could be a better strategy to increase formalization of firms or employment. The greatest impact in inducing firms and employment to formalize may come by combining policies that involve information provision, lower time and monetary costs of formalization and enforcement.

For policymakers, the ultimate objective must be to support the transition to formality. Enforcement and design of the legal and institutional frameworks are prerequisites for reducing informality. The relevant legal and institutional frameworks include those that govern labor, social protection, and business regulations as well as access to financial capital and securing property rights. This requires an integrated strategy to bring informal workers and entrepreneurs into formal channels of protection, support and responsibilities with registration, while preserving their resilience and dynamic potential.

Wider development policies are also important. These could include economic growth promoting policies and providing skills training programs to upgrade the skills of workers and entrepreneurs in the informal economy. Also, microfinance and reforms for extension of social security coverage can facilitate a move out of informality.

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