Reducing the Costs and Enhancing the Benefits of Formality

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From the Firm’s Perspective
REDUCING THE COSTS AND ENHANCING THE BENEFITS OF FORMALITY: FROM THE FIRM’S PERSPECTIVE

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ABSTRACT

The high incidence of informality in developing countries acts as a drag on economic development due to the associated efficiency and equity costs and implied weak governance. Policy makers therefore want to reduce informality. This note presents guidance on policy levers to make formality more attractive and informality less attractive from the perspective of small, medium and large firms, and from the perspective of micro-entrepreneurs. It elaborates the challenges for shifting incentives in favor of being formal and employing workers on formal contracts rather than operating under the regulatory radar, and presents a range of policy options.
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1. INTRODUCTION

In the developing world, most workers and many firms are informal in that they are largely unregulated. While dominant in developing economies, informality is becoming increasingly prevalent in advanced economies. The informal economy encompasses many different types of workers and enterprises engaged in a wide range of activities and in various sectors, reflecting a “complex, multifaceted phenomenon”.1 These activities may lie outside the scope of regulation, or may be covered by laws or regulations that are not enforced, whether because it is too costly to do so, or because the necessary institutional capacity is lacking. The informal economy can therefore include legitimate activities as well as illegal activities.2 Economic activity can moreover reflect different degrees of informality.3 In this note, we refer to the informal economy or informal sector as those activities and incomes that fall outside of government regulation, taxation, social security coverage, or reporting.

Informal activity and informal employment can be sub-optimal with respect to efficiency, equity and governance, acting as a drag on economic development.4 Informal work tends to be less productive and rely on less skilled labor inputs with fewer opportunities for skill accumulation or technology upgrading, constraining the growth rates of highly informal economies due to low added value. This in turn leads to low income per capita levels that can persist in the future. Low informal earnings – especially for subsistence farmers and micro-entrepreneurs – limit disposable incomes and thus provide little support for aggregate demand through households’ consumption of local goods and services. Even non-subsistence informal workers are likely to make only limited contributions to aggregate demand given that informal earnings average less than the national minimum wage (Ruppert Bulmer, forthcoming). Low incomes stifle investment in physical and human capital, and negatively impact firm growth and aggregate fiscal revenues, with knock-on effects for public services, including those that enhance human capital and private sector productivity. Efficiency costs also arise from unfair competition, as informal firms face low tax and compliance costs, creating incentives for evasion that can undermine regulatory regimes already suffering from weak governance. Although informal employment may account for most employment in the developing world, the contributions of informal workers and producers to national output falls in the range of 25-50 percent of GDP.5

For these reasons, policy makers want to reduce informality. This note presents guidance on policy levers to make formality more attractive and informality less attractive from the perspective of small, medium and large firms, and from the perspective of micro-entrepreneurs. It elaborates the challenges for shifting incentives in favor of being formal and employing workers on formal contracts rather than operating under the regulatory radar, and presents a range of policy options.

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1 Loayza, 2016.
2 ILO, 2002.
3 Workers employed in unregistered firms are informal, but so too are undeclared workers employed in formal firms, or formal employees whose earnings are underreported. Similarly, formal firms may declare only a portion of their revenues. See Benjamin and Mbaye, 2012, for a discussion on definitions and measurement.
4 See Ruppert Bulmer (forthcoming) for a detailed discussion.
5 Schneider et al., 2010; Hassan and Schneider, 2016.
2. INCENTIVIZING FORMALITY

Firms weigh the formality decision through a cost-benefit lens. This is the case at inception – that is, when firms seek to register with the regulatory and tax authorities. The formality decision arises throughout the operational stage, and is a question of degree; firms can choose to be in full compliance with laws and regulations, or can opt for some intermediate status of partial compliance with a subset of requirements such as income reporting for tax purposes, cost reporting which has implications for labor tax obligations, and/or non-financial regulations such as labor protections, workplace safety rules, health regulations, or environmental management requirements. These non-financial regulations impose a non-trivial cost on firms, and therefore factor into the formality decision.

The decision to be formal may not, in fact, be a true choice, if informality is the result of exclusion. This is the case when firms operate on the margin between profitability and subsistence; they may not be able to bear the costs of compliance with legal or regulatory requirements. In Paraguay, for example, where firm census data allow us to compare average firm productivity with average firm wages for both formal and informal firms, we observe a significant number of firms whose productivity and wages are below the minimum wage. For these firms, complying with the minimum wage law would put them out of business.

Many argue that informality is the result of voluntary exit rather than exclusion; informal workers and firms opt out of the formal sector to avoid taxes and other regulations from which they derive little value. The empirical literature offers significant evidence that informality can be a voluntary rational choice. Whether driven by exclusion or voluntary exit, the cost burden of complying with laws and regulations plays a part in the decision to be formal or informal.

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6 As argued by La Porta and Shleifer, 2014.
3. ADDRESSING LABOR COSTS

Labor costs and the associated labor taxes for formally declared workers represent a substantial cost for firms. Labor costs comprise net wages paid to workers, the employer’s portion of the labor tax levied on wages to finance employees’ social insurance, and the indirect cost of labor regulations relating to worker protections (e.g., limits on work hours, mandated vacation and sick leave, workplace safety arrangements). The main objective of labor taxation is to finance the provision of social insurance benefits to contributing workers. Social insurance typically includes unemployment insurance, health insurance, and old age, disability and survivors’ pensions, and eligibility and benefit level are contingent on contribution level and therefore reported wage earnings.

High labor taxes reduce formal employment. There is a growing body of empirical evidence on the negative effects of labor taxes on employment and wages. A number of studies find that high labor taxes have a negative impact on employment, and tend to increase unemployment rates; other studies are less conclusive. Several empirical studies identify a positive relationship between the tax wedge on labor income and unemployment. The size of the employment effect due to a change in labor costs (i.e., the labor demand elasticity) is estimated around -0.30 to -0.50 in industrialized countries (i.e., a 10 percent decrease in the cost of labor would cause employment to rise from between 3 and 5 percent; see Annex Table 1). In comparison, several studies from developing and transition countries estimate (long run) labor demand elasticities in the -0.20 to -0.60 range.

Colombia and the UK provide recent evidence that formal employment increases when labor taxes are lowered. Under Colombia’s 2012 reform, payroll taxes were reduced by 13.5 percentage points. This reform was introduced in an environment of very high non-wage labor costs exceeding 60 percent of the average wage, and very high informality rates ranging from 56 to 67 percent of the total labor force. According to a series of studies commissioned by the Inter-American Development Bank, Colombia’s payroll tax reform increased the number of formal jobs by over 3 percent and increased wages by between 1.9 and 4.4 percent, with most of the impact among small and medium-sized enterprises. Steiner and Forero (2015), Anton (2014), and Hernandez (2012) find that the tax reform increased formal employment by between 3.4 and 7.4 percent of total employment and reduced informality by between 1.4 and 4.2 percent. In the UK, the 1999 increase in the National Insurance Contribution (NIC) of employers and employees by 1 percentage point each is estimated to have slowed nominal wage growth and shifted the tax burden from low-wage to high-wage earners.

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11 Nickell and Layard, 1999; Daveri and Tabellini, 2000; Nickell et al., 2005; Ohanian et al., 2008.
12 Vroman and Brusentsev, 2005; Rutkowski, 2007.
14 Bernal, 2009; Mondragón-Vélez et al., 2010.
15 Steiner and Forero, 2015; Kugler et al., 2017; Bernal, Eslava, and Melendez, 2015.
16 Bell et al., 2002.
At least part of employers’ labor taxes is shifted onto employees through lower wages, such that the intended beneficiaries – formal workers – partially lose out. The resulting ‘pass-through’ effect varies in magnitude, and can be quite large in middle-income countries. Research in Latin America suggests that 20 to 70 percent of the employer’s social security contributions are passed on to the workers, and in some cases close to 100 percent. This means that a large part of changes in payroll taxes is transferred to workers through lower wages, but with a marginal effect on employment level. According to the Melguizo and González-Páramo (2012) meta-analysis of 52 empirical studies, workers within Continental and Anglo-Saxon economies incur about two-thirds of employers’ labor tax burden in the long run, compared to around 90 percent for the Nordic economies. High values have also been estimated by Gruber (1997) in Chile where the pass-through is almost total, and by Cruces et al. (2010) in Argentina, where the “pass-through” is between 40 and 90 percent.

High labor taxes not only reduce labor demand and wages; they can also contribute to informality. Mondragón-Vélez et al. (2010) study the effect of non-wage labor costs on the probability of being informal in Colombia, concluding that an increase of 10 percentage points in non-wage costs is associated with a 5 to 8 percentage points increase in the probability of being informal. When comparing countries at similar stages of development and similar per capita income levels, higher labor tax rates are associated with a larger shadow economy. For example, Davis and Henrekson (2004) find that for a sample of 14 rich countries in the mid-1990s, a unit standard deviation tax difference of 12.8 percentage points is associated with, among other things, a rise in the shadow economy of 3.8 percent of GDP, corresponding to a 24 percent increase in the size of the shadow economy evaluated at the mean.

Achieving the right tax-benefit balance may require tightening the link between employers’ social security contributions and the benefits that firms derive from these labor tax-financed programs. Social security contribution rates can be very high, particularly in advanced economies (see Annex Figure 1). This is partly explained by generous social benefits and population dynamics; but employer contribution rates sometimes incorporate a redistributive component to finance other social objectives, and may be perceived as a pure tax with no direct benefit to them or their employees. Employers benefit from unemployment insurance and old age pensions because they replace severance cost requirements and employer-only financed retirement benefits. Health insurance keeps employees healthier and more productive at work. Employment injury insurance – typically paid only by firms – can be cost-effective for spreading employers’ risk across a larger pool of potential beneficiaries while protecting workers. Employer contributions to social insurance should be limited to financing these programs.

Labor tax rates could be structured to accommodate small firms’ limited capacity. In addition to streamlining social insurance costs and benefits, contribution rates could be tailored to firms’ capacity to pay. In some countries, social insurance contribution rates are discounted for small enterprises, such as in France, where companies with less than 20 employees pay a reduced employer contribution equivalent to a flat-rate of €1.50 per hour to finance general health insurance for employees and for

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17 World Bank, 2009.
18 Azemar and Desbordes, 2010; World Bank, 2009; Heckman and Pagés, 2004; Ooghe et al., 2003.
19 Other programs are sometimes financed by mandatory firm contributions, such as in-service training; but when this is mandatory, all contributing firms should be able to access training support for their own workers. Directly linking financing and benefits will generate greater buy-in by firms.
accidents at work and occupational illnesses. Smoothing labor tax rates to reduce firms’ effective marginal tax rate on added labor would improve the incentive to declare employees’ earnings.\textsuperscript{20}

**Redistributive components could be shifted from firms (and workers due to pass-through) to different types of taxation as a means of reducing the labor tax wedge and spurring formal labor demand.** For a given tax revenue, a revenue-neutral partial shift from social contributions to other revenue sources such as consumption or wealth taxes (e.g., value added taxes, excise taxes, property taxes, etc.) may improve employment outcomes, including reducing incentives for under-declaring earnings per employee and thus increasing tax revenues.\textsuperscript{21} Consumption taxes have a broader tax base than social contributions, requiring a lower tax rate.\textsuperscript{22} On the other hand, consumption taxes tend to be regressive. Bulgaria provides an example of alternative financing for a redistributive policy, namely that the state budget finances a portion of an employer’s contribution for workers with disabilities. Bulgaria also shifted to financing active labor market policies from the general budget rather than the contribution-financed Employment Fund.\textsuperscript{23} The other main revenue-generating areas for government are taxes on income and profits (which again risk depressing formal labor supply and labor demand), property taxes (typically progressive), environmental taxes, and selling government assets (for a temporary wind-fall). Whereas shifting from labor taxes to consumption taxes may make formal labor inputs less expensive and increase formal sector output, it can also reduce the demand for formal outputs subject to VAT in favor of informal goods and services. Leibfritz (2011) points out that the net effect will depend on specific country circumstances. Evidence from several transition countries (namely Armenia, Bulgaria, Estonia, Kazakhstan, Slovakia, and Russia) suggest that tax rate cuts were revenue-increasing; the larger the share of informal business activity before the reform, the higher the revenue growth after.\textsuperscript{24}

**Indirect labor costs can be significant, and their size and impact are harder to measure compared to direct labor costs.** Kuddo, Robalino and Weber (2015) address minimum wages, dismissal procedures and severance pay policies and provide guidance on policy designs that balance the need for labor market regulation with promoting job creation. For example, making the minimum-wage setting mechanism more transparent provides potential employers with more visibility on future wage increases. In addition to minimum wage, dismissal and severance requirements, formal firms may be required under national labor laws to provide worker protections ranging from caps on work hours and minimum paid vacation time to paid sick leave, which directly reduce worker output and therefore labor productivity. Other protections can impose additional indirect costs on firms, such as upgrading facilities to ensure safe and healthy working conditions, and allowing workers freedom of association, which enables increased agency. Whereas these core labor standards – protected under ILO conventions – are essential for safeguarding workers’ basic rights, the associated costs may dissuade compliance by firms. The degree to which labor conventions are effectively implemented varies widely across countries and even jurisdictions within countries, and depends on administrative and enforcement capacity (discussed below).

\textsuperscript{20} Packard, Koettl, and Montenegro, 2012.
\textsuperscript{21} OECD, 2007.
\textsuperscript{22} For a discussion on the pros and cons of payroll or consumption taxes in financing social expenditures in developing countries, see for example Levy, 2008; Bird and Smart, 2014.
\textsuperscript{23} EC, 2017.
\textsuperscript{24} World Bank, 2006.
4. ADDRESSING NON-LABOR COSTS AND REGULATIONS

Policies to reduce formal firms’ costs can focus on income or profit taxes. Governments can smooth tax rates on firms through graduated profit taxes, for instance by introducing intermediate rates where current effective marginal rates spike. Firms with rising profits may forgo expanding their operations or declaring additional revenue if most added profits are taxed away. As an alternative to taxing on self-reported profits, some countries impose taxes using administrative criteria, which are more transparent and verifiable compared to self-assessments by firms, and can implicate a larger tax base. Presumptive systems may, for instance, calculate taxable income using observable factors associated with income such as sales, turnover, number of employees, or assets, to capture at least some minimum level of tax from firms considered to be unreliable sources of information on their own activities.\(^{25}\) Evidence suggests that providing tax relief targeted to small firms is no more effective at increasing aggregate employment than general tax relief for businesses, however. In fact, special relief may hurt economic growth by creating a small-business trap, preventing small firms from growing larger to maintain their special tax treatment.\(^{26}\)

Other costs incurred by formal firms stem from regulations that control the operating environment such as direct registration fees and business licenses, importing or exporting fees and administrative procedures, operating permits (e.g., for driving, construction and health regulations, and accreditation), and the time necessary to meet bureaucratic and tax reporting requirements.\(^{27}\) Operating in the informal sector can be more efficient from the firm perspective when the regulatory environment is highly distorted.

A host of complementary factors figure into firms’ calculation of the pros and cons of doing business formally and in full compliance. In principle, an enabling environment for firms would include a well-functioning infrastructure network, widely accessible education and health services of high quality, trade and competition policies that ensure a level playing field while nurturing new players, regulations that balance firms’ and workers’ rights, and a fair judicial system that can enforce property rights, contracts and the rule of law in a timely manner. These enabling factors benefit both formal and informal firms, and even society at large, which can distort the willingness to pay for these services since informal beneficiaries do not pay taxes. A weak business environment facilitates informality, and excessive informality undermines a conducive business climate. The resulting vicious cycle can drive down productivity when, for example, informal or irregular firms cannot attract educated workers or engage them long-term, ultimately reducing firms’ incentives to invest in training and productivity upgrades. Similarly, informal firms unable to access credit, larger markets, or sources of innovation may operate at a suboptimal scale. When formal firms have to compete with non-complying firms, formal


\(^{26}\) Jobs created by small firms are also generally of lower quality than jobs created by large firms, with the former paying lower wages, offering more modest health insurance and pension plans, and providing poorer working conditions. See Brown et al., 1990; IMF, 2012.

\(^{27}\) According to World Bank Enterprise Surveys data (http://www.enterprisesurveys.org), senior managers in manufacturing firms spend on average 10 percent of their time dealing with the requirements of government regulation, with a higher time burden in LAC (14 percent of senior managers’ time) and a lower burden in East Asia and the Pacific (6 percent). For details on the business environment in 190 countries see World Bank, 2016.
sector productivity falls, dragging down average productivity. On the other hand, in economies where informal and formal activities have limited overlap, as suggested by La Porta and Shliefer (2014) among others, this effect may be small. In the context of a weak business climate, it is important to design additional incentives targeting firms on the margins of formality, typically small firms that can avoid government scrutiny by operating in the shadows at low scale.

**Corruption, or even the perception of official corruption, will discourage formality.** In settings of weak governance, firms may even be required to pay bribes for the privilege of operating formally; this in itself can be directly linked to the formality decision if inspectors or permit issuers demand bribes. World Bank enterprise survey data indicates that 18 percent of manufacturing firms globally have experienced at least one bribe payment request, with regional averages ranging from 30 percent in East Asia and the Pacific, to a more modest two percent in high income OECD countries. Effective policies in these weak institutional settings need to be simple, transparent, based on readily observable criteria, and easily enforced.

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28 According to Farrell (2004), informality accounts for around 50 percent of the productivity gap between countries like Turkey, Portugal, and the United States; and for 30 percent of the productivity gap between Brazil and the United States.

5. ENFORCEMENT: CARROTS VS. STICKS

Informality due to partial or complete evasion is facilitated by imperfect enforcement. When rules and regulations are onerous or complex or inconsistent, firms are less likely to comply. Government efforts to enforce compliance face challenges related to administrative capacity and information gaps, inter alia. When governments do not know where firms are, their level of output, and who they employ, it is difficult to extract the appropriate level of profit and labor taxes and business fees, for example. And when there are minimal negative consequences for evasion or underreporting, firms’ incentive to comply diminishes further.

One clear example relates to tax enforcement, where weak governance limits effective tax collection, inducing even more informality. Poor tax enforcement is especially problematic in developing countries with weak governance. Challenges include “(i) dealing with sectors that are ‘hard-to-tax’ everywhere (small businesses, including small farmers, professionals, and, in some cases, state-owned enterprises), especially where administrative capacity and compliance habits are weak; and (ii) weak revenue administrations, low taxpayer morale, and poor governance.”30 Moreover, a large informal sector leads to a high tax burden on registered firms because of the narrower tax base, creating negative reinforcing effects that are more likely to tip the cost-benefit equation in favor of informality.31

The prevalence of small firms in developing economies makes enforcement particularly difficult, given that tax and social security evasion is more common among smaller firms. Perry et al. (2007) show that in Bolivia and Mexico, one-third of sales go unreported among microenterprises, compared to 10-15 percent among firms with 100 workers or more. In Panama, Peru, and Uruguay, by contrast, large firms appear to evade taxes and social security contributions at rates that are comparable to those of smaller enterprises, which average between 10 and 15 percent in Peru and Uruguay, and above 30 percent in Panama.32

Costly regulations and taxes drive firms underground; even minimal regulations may dissuade firms from registering or accurately declaring their income and assets. The first step in promoting compliance is to make it easier for firms to meet regulatory requirements by reducing their direct and indirect costs and simplifying the reporting and payment processes. Addressing the compliance incentives for firms – such as by reducing or smoothing tax rates, eliminating duplicate or contradictory registration steps, focusing on a small number of fees, cutting minor fees altogether, reducing the time burden of red tape, and/or raising the perceived value of being formal – will increase firms’ willingness to pay. High quality public goods and services will increase tax morale – that is, the intrinsic motivation to pay taxes33 – whereas money lost to poor political decisions and corruption will tend to decrease it.34

Simplifying the tax regime by reducing tax rates and eliminating exemptions is the main way to reduce corruption in tax administration. Aligning firms’ and tax authorities’ incentives also induces cooperation. This can be achieved, for example, by: holding firms accountable for the tax compliance of their subcontractors; encouraging employer and trade union denunciation of unfair competition; and

30 IMF, 2011.
31 Kudo and Rutkowski, 2011.
32 Perry et al., 2007.
33 Alm and Torgler, 2006, 2011; Cannari and D’Alessio, 2007; Cummings et al., 2009; McKerchar et al., 2013; Torgler, 2011; Torgler and Schneider, 2007.
34 OECD, 2009.
enforcing employee rights such as protection against unfair dismissal even for undeclared work relationships.\textsuperscript{35}

Once the basic incentive structure is set, there could be added incentives designed to entice firms at the margins of formality, whether small firms contemplating complete evasion, or large firms under-reporting their employees and/or profits. This “carrot” approach can take many forms. For example, employer contribution ceilings could induce employer participation and avoid encouraging wage restraint or under-reporting.\textsuperscript{36} Amnesties on past tax liabilities could bring in firms seeking a fresh start. Pre-payment discounts could encourage accurate and timely tax payments.\textsuperscript{37} Providing pre-filled tax returns based on observable data is likely to increase compliance and revenues, based on a pilot tested in California for individual income taxes.\textsuperscript{38} E-reporting and e-tax payments through mobile applications can reduce administrative capacity and time requirements, ease the burden for small firms in particular, and reduce opportunities for corruption.\textsuperscript{39} Positive incentives will be especially important in developing economies, where informality rates are high and administrative systems and government enforcement capacity tend to be weak.

Complementary public information campaigns can be effective tools for promoting positive incentives and disseminating registration and tax rules to firms with weak attachment to official systems. Labor unions or informal workers’ associations can also play a role in raising awareness of labor rules, empowering workers to demand compliance by their employers.\textsuperscript{40}

Minimally effective or credible enforcement is a necessary precondition if firms are to comply. There are two complementary channels for strengthening enforcement: administrative capacity, and sanctions. Improving administration often includes: a reorganization of agencies involved with compliance to rationalize responsibilities across agencies; creating consistent systems and direct coordination links for data-sharing between fiscal authorities, customs agencies, social security agencies and labor and tax inspectorates on the basis of unique taxpayer ID numbers; and revising staff responsibilities to reduce discretion and strengthen accountability lines. Perry et al. (2007) propose that institutional capacity building address three main aspects of tax administration: taxpayer registration, audit, and collection. Taxpayer registration can be enhanced through better use of third-party information (for example, cross-references between tax reporting, social security records, and data from the financial system). Audits can be more effective by adopting modern audit technology. In most countries, there is scope for reducing administrative and compliance costs and increasing collections through changes in tax structure, combining reductions in marginal tax rates with the elimination of exemptions.

These administration-focused reforms can be complemented by stiffer penalties for non-compliance. More intense auditing by tax and labor agencies and stiffer penalties for violators are major weapons to combat undeclared economic activity; however, there are limits to what these measures can achieve.

\textsuperscript{35} OECD, 2004.  
\textsuperscript{36} Ceilings on contributions on insurable earnings can be established as a fixed amount (e.g., as in Spain, Cyprus, Bulgaria), as a multiple of average wages (e.g., in Slovakia, Romania, the Czech Republic) or of the minimum gross wage (e.g., Romania for sickness and maternity benefit contributions), or using some other benchmark (see EC, 2017).  
\textsuperscript{37} See OECD (2015) for an overview of voluntary disclosure programs in OECD countries.  
\textsuperscript{38} Mayyasi, 2017.  
\textsuperscript{39} See OECD (2010) for a discussion of electronic taxpayer services in OECD countries.  
\textsuperscript{40} ITUC, 2016.
alone. For instance, heavy auditing and excessive sanctions risk driving some firms and entrepreneurs more deeply into informality or out of operation altogether. To avoid this, the right mix of prevention and sanctions is needed. Administrative measures can also incorporate better public education and information to shape the perceptions of firms vis-à-vis the merits of operating in the formal sector and contributing to the public good by strengthening formal systems.

**With respect to labor standards, in most countries labor inspection agencies monitor compliance.** Labor inspection units tend to operate as part of the labor administration. But most labor inspection units have a dual nature that can impede or at least complicate monitoring. On one hand, labor inspectors enforce legal provisions dealing with labor regulations, occupational health and safety, social services, migrant workers, vocational training, social security, and other areas where firms are regulated. On the other hand, labor inspectorates play a collaborative role with firms to provide information, advice and training. Given that many compliance irregularities occur in small-scale enterprises or in sectors with high staff turnover, inspection activities tend to focus on such firms, and in sectors like construction, hotels, garment manufacturing, transport and commerce. The ILO contends that resources for labor inspection are inadequate in most countries.

Enforcement strategies require country-specific approaches tailored to the political, historical, and economic culture of the country. But the main instrument available to labor, social security and tax inspectorates for detecting undeclared work is the unannounced site visit. This instrument is effective in ensuring that most workers are registered. Some countries carry out joint inspections, such as El Salvador, which has a special integrated inspection unit, and Belize, where inspections are conducted jointly between the Social Security Board and the Labor Department.

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41 World Bank, 2008.
42 ILO, 2005.
43 ILO recommendations on the optimal ratio of labor inspectors to workers are: 1/10,00 in industrial market economies, 1/15,000 in rapidly industrializing economies, 1/20,000 in transition economies, and 1/40,000 in the least developed economies. Most countries miss these benchmarks, however. The ratio between inspectors and active population range from one inspector per 5,500 active workers in Malaysia, to one per 8,300 workers in Latvia, one per 45,000 in Burkina Faso, one per 370,000 in Cambodia and one per 3,200,000 in Bangladesh. See ILO, 2006.
44 See for example European Commission, 2004; World Bank, 2008.
45 OECD, 2004; ILO, 2011.
6. DIFFERENTIATING TAX REGIMES TO ENTICE MICRO-ENTREPRENEURS INTO FORMALITY

Like larger firms, micro-entrepreneurs\textsuperscript{46} must elect whether to register with the relevant authorities, or operate outside the formal sector. Given that evasion is relatively easier for micro-firms, many of which operate in private rather than commercial settings, the cost-benefit calculation is different compared to that for larger firms because the likelihood of detection or sanctions is low. Even for those registered, the degree of formality is a choice; micro-entrepreneurs may be tempted to under-report their earnings to reduce their tax burden.

From the perspective of a micro-entrepreneur, being formal brings some benefits but not others. For a registered entrepreneur, participating in social insurance brings income transfers in the event of unemployment and old age, health services in the event of illness, and access to employment injury insurance for oneself and one’s employees. The remaining protections that typically come with being formal are irrelevant for self-employed micro-entrepreneurs: labor protections such as limits on work hours or mandatory vacation are decided by the self-employed worker directly through his/her own labor decisions, as are workplace safety, health and environmental precautions. These additional protections therefore have zero perceived benefit. The disadvantages of being formal include costly contributions to social insurance for oneself and any employees, profit taxes, business operating license fees, administrative processing and reporting requirements, and for entrepreneurs with employees, the payment of minimum wage and severance, and compliance with dismissal rules.

Recall that when economic agents, whether firms or workers, perceive that the benefits of formality are outweighed by the costs, they rationally choose to exit formality. The challenge is to provide the benefits of formality in a format that meets micro-entrepreneurs’ needs at an affordable cost. These needs, and the types of policies that will be effective in addressing them, depend on the productive capacity of micro-entrepreneurs. For workers who are self-employed because they have been excluded from more productive formal sector work, their capacity to develop a business with growth potential may be limited; this would be the case for so-called ‘subsistence’ entrepreneurs performing low-level services or small-scale household production as employment of last resort.\textsuperscript{47} If, on the other hand, workers voluntarily choose to become entrepreneurs, their capacity to increase productivity and ultimately expand output and create formal jobs could be harnessed through a range of interventions.

Although the main benefit of being formal is access to social insurance, most existing social insurance programs are designed to accommodate traditional patterns of formal employment that are ill-suited to micro-entrepreneurs. For a self-employed entrepreneur, the employer and the employee are the same person, such that the effective combined contribution rate (i.e., employer plus employee) is disproportionate to the value of the benefit, and in many cases is unaffordable. Similarly, in a micro-enterprise employing unpaid family labor, there is no wage, effectively precluding the unpaid family worker from coverage. To address these coverage gaps, many countries have extended social insurance

\textsuperscript{46} Size-definitions of micro-enterprises vary. In this note we consider a microenterprise as an employer with up to 5 employees. The EU definition, by contrast, allows up to 9 employees and with annual turnover below EUR 2 million.

\textsuperscript{47} Kuddo and Rutkowski, 2011.
to the self-employed, achieved by adjusting contribution levels and methods, reducing the level of benefits (mostly excluding unemployment insurance and reducing pension benefits), and/or subsidizing the employer contribution (see Winkler, Ruppert Bulmer and Mote (2017) for a detailed treatment). Other countries have created separate systems for the self-employed, such as the farmers’ system in Poland and the lawyers’ system in Romania. Separate social insurance schemes are more difficult to sustain due to inadequate risk pooling, and the potential correlation of risks across similar workers (e.g., farmers vulnerable to weather-related shocks).

Reducing labor tax contributions is the most common instrument for attracting the self-employed and micro-entrepreneurs into formality. These take the form of exemptions from certain payroll deductions, reduced tax rates, or reduced bases on which these obligations are assessed (for a detailed discussion see OECD, 2015). In Germany, for example, the self-employed are exempt from mandatory pension contributions, and can apply to the statutory pension insurance scheme within 5 years of becoming self-employed. In Argentina, employers with a turnover of less than ARD 48 million and those who perform industrial, agricultural, livestock or mining activities benefit from a reduced social security contribution rate of 17 percent, compared to a normal rate of 26 percent. Canada’s Small Business Job Credit applies to small firms whose Employment Insurance employer premiums were less than or equal to CAD15,000 in 2015 and 2016. In Poland, self-employed persons pay social security contributions on a lower base that is not less than 60 percent of the projected average monthly wage.

Many countries apply both minimum income floors and maximum income ceilings for calculating the social insurance contribution. The minimum contribution threshold typically coincides with the minimum qualifying income for the self-employed. In most EU countries a minimum income floor is not applied as a condition, given micro-entrepreneurs’ irregular income structure. Because self-employment income tends to be lumpy and can vary widely from year to year, most EU systems are structured to accommodate negative or zero net income years through e.g., postponement of the contribution payment, waiving the contribution payment, or applying a reduced contribution rate, rather than excluding affiliates from the system. In several Central and Eastern European countries, when income falls below a minimum level, the self-employed drop out of the system; but this is counteracted by setting the minimum thresholds low so that most low-earning self-employed people still qualify for coverage. Imposing a maximum contribution ceiling helps attract high-earning self-employed who may otherwise forgo social insurance.

48 Bonnet (2015) describes the rapid extension of legal coverage to the self-employed since the 1990s. In 2013, 147 of the 181 countries examined provided pension coverage for the self-employed, twice the proportion in 1990. Globally, as of 2013, 77 percent of the self-employed were legally covered by some type of pension scheme, compared with 29 percent in 1990. Over the same period, the covered share increased by a factor of 8 in low-income countries and by a factor of 4 in middle-income countries.

49 EC, 2016.

50 The minimum amount in 2015 was PLN 2,375 and the limit of the annual basis for pension and disability contributions was PLN 118,770. Self-employed persons also pay health care contributions against a lower assessment basis.

51 The minimum qualifying income for the self-employed is equal to the minimum wage in Bulgaria, Estonia and Slovenia; the minimum contribution basis in Latvia; 30 percent of the minimum wage in Hungary; three times the gross average monthly salary in a year in the case of Romania; and specific income levels in the Czech Republic and the Slovak Republic.

52 See EC (2015) for a discussion.

53 Schoukens, 2002.
Policies to reduce costs for other business-related regulations include lower profit tax rates for new firms, with rates increasing over time or in line with profits, thereby smoothing the marginal tax rate. Both measures keep the initial burden low for start-ups, and thus encourage registering. Setting business licensing fees and other regulatory payments proportional to the size of the operation also accommodates micro-entrepreneurs’ low payment capacity. But recent evidence from programs in Brazil (de Andrade, Bruhn and McKenzie, 2013) and Benin (Benhassine et al., 2016) shows that efforts to waive registration costs and provide registration information were insufficient to induce firms to formalize and remain formal.

In light of micro-entrepreneurs’ limited administrative capacity – whether due to time pressures or capability – efforts to alleviate the compliance burden have been introduced in many country settings. Compliance can be encouraged through less frequent filing of tax returns, or simplified accounting methods to determine tax liability. Brazil introduced a single tax for SMEs, the Simples Nacional regime, which can be paid in place of eight taxes. Brazil also introduced a flat tax for self-employed workers under an income threshold. Hungary’s KATA regime is a lump-sum tax for self-employed who are released from other tax obligations including corporate income tax, personal income tax, a social contribution tax, and healthcare, pension, employment and vocational training contributions. In countries using a presumptive tax scheme, firms below a small-business threshold are exempt from regular income tax, and the firm’s tax liability is calculated on the basis of an observable proxy such as annual revenue or some other measure reflecting firm size. Eligibility is generally determined by an annual revenue threshold. Some countries also specify a maximum number of employees (e.g., Brazil, Czech Republic, Poland and Slovenia), and in some countries, tax rates vary by type of business activity (e.g., Brazil and France).

54 Entities with gross revenues of up to BRL 3.6 million can choose the Simples Nacional regime, subject to restrictions (Fajnzylber et al, 2011). This scheme replaces several other taxes, including Contribution for the Financing of the Social Security (COFINS), Social Contribution on Net Profit (CSLL), Tax on the Circulation of Goods and Transportation and Communication Services (ICMS), Tax on Industrialized Products (IPI), Tax on Services (ISS), Corporate Income Tax (IRPJ), Social Integration Program or Civil Servants Savings Program Contribution (PIS or PASEP) and social security contributions (CPP).

55 Brazil’s Microempreendedor Individual regime applies to self-employed natural persons, with up to one employee (who is remunerated at the minimum wage). The entity must have an income that is less than BRL 60 million per year. Under the regime, the taxpayer is exempt from federal taxes and pays a fixed monthly amount toward social security.

56 Under the KATA regime, full-time entrepreneurs registered as small business taxpayers pay tax of HUF 50 000 per month. Taxpayers may elect to pay HUF 75,000 per month in return for higher social security service eligibility. Part-time entrepreneurs pay HUF 25,000. The lump sum tax is payable separately for each person registered as a small business taxpayer, and applies up to a revenue limit of HUF 6 million. Revenues exceeding this amount are taxed at 40 percent.
7. SUPPORTING MICRO-ENTERPRISES THROUGH OUTREACH AND INDIRECT ENTICEMENTS

To increase compliance, tax rules – whether complex or newly simplified – need to be clearly communicated to taxpayers; this goes for firms, entrepreneurs and workers. Large firms tend to have accounting staff to keep records of the firms’ accounts and file the necessary tax returns. But small firms and micro-entrepreneurs are less likely to have a dedicated bookkeeper, and may be ill-equipped to perform these functions. Moreover, they are less likely to be aware of the latest tax reporting requirements. Widespread and accessible communication and public information campaigns on tax rules, and more direct support through e.g., hotlines or community outreach programs will increase transparency and ease the administrative burden for the self-employed and micro-entrepreneurs in particular. But as mentioned above, evidence from Benin suggests that information campaigns alone were insufficient, while adding a personal visit to the micro-enterprise had a significant positive impact, but at an excessive implementation cost.57

It may be that even when tax rates and other compliance costs are low and tax reporting and administrative processes are simple, micro-entrepreneurs remain resistant to formalizing. This will be the case especially for low-income micro-entrepreneurs because they lack the profit margins to be make formalization a credible option. Additional enticements to formalize may be needed. The most effective will be those that help reduce the obstacles to higher productivity and expanded output. Instruments meeting this criterion include: interventions to increase access to credit and financial intermediation; programs that directly ease credit constraints through matching grants (with mixed evidence on their effectiveness)58; partly-subsidized training programs to support business skills development and/or technical knowledge (a cost-sharing component is important for better targeting); mentoring or partnering programs that connect micro-entrepreneurs with larger firms operating in the same market or value chain; marketing and export promotion assistance to improve access to larger internal and external markets. The fiscal cost of these incentives may be offset by the resulting productivity gains when recipients are entrepreneurial and have growth potential; it is when these incentives go to very low-productivity subsistence entrepreneurs that the fiscal outlay may not generate positive returns. Distinct policies that target incentives to micro-entrepreneurs with different levels of productivity may yield larger positive effects for the entrepreneurs in each category.

57 Benhassine et al., 2016.
8. CONCLUSIONS

High informality rates in developing economies stem from multiple factors. These include burdensome or distorted regulations and high tax rates that encourage firms to evade or under-report; operating informally allows employers, paid employees, and micro-entrepreneurs to increase their take-home earnings or reduce their costs by evading taxation, social security contributions and other costly workplace protections. The implementation and enforcement capacity of government institutions in low-income countries tend to be insufficient to foster high rates of compliance. Weak governance, which is prevalent in many developing economies, engenders informality and reduces fiscal revenues, undercutting institutional effectiveness and further reducing the returns to being formal. For entrepreneurs seeking to set up or expand operations, limited access to skills, technology and/or markets constrain their potential productivity and therefore incomes, relegating producers to low-productivity activities sometimes at the margins of profitability. And firms facing a difficult business environment typically incur high operating costs that affect labor and non-labor inputs, and impose time-consuming administrative requirements. Some of these factors limit firm entry; others constrain formal labor demand and output growth.

Policy makers worried about the negative implications for productivity, growth and fiscal balances seek the best policy approaches for reducing the costs and enhancing the benefits for firms to register and operate formally. This note identifies a range of challenges for inducing firms of all sizes to comply with legal and regulatory requirements. Large and more productive firms may have the capacity to comply with fair rules, but micro-enterprises face much higher constraints. Moreover, micro-enterprises find it easier to evade reporting and sanctions. Careful impact evaluations of policy effectiveness are relatively scarce. Some policies are shown to be effective, but other evidence is more mixed.

Whereas policy lessons from international experience are insightful, they need to be customized. Policymakers may consider designing policies to fit their specific country context, and piloting policy changes on a small scale before rolling out reforms at the national level. This careful approach will increase the likelihood that the desired policy objectives will be met.

Given the large number and complexity of factors driving informality, a multi-pronged policy approach is likely to gain the most traction. Policies should address both labor and non-labor factors. Labor taxes should be limited to financing social insurance, where contributions and benefits are closely linked in a transparent way, and employers and employees share the contribution burden. Smoothing marginal effective tax rates – whether for labor or profit taxes – can create positive incentives for job creation and firm growth. Accommodating the lower administrative and payment capacity of small firms is important, and could be effected through consolidated processes or graduated regulations, for example. Moreover, small firms operating at the margins of formality may need additional enticements, preferably designed to diminish obstacles to raising their productivity. Simplified tax rates and regulations are easiest to communicate and implement – regardless of firm size – and could be based on readily observable factors as an alternative to relying on firms to self-report. Government efforts to enforce compliance complemented by a framework of fair sanctions are essential to effective implementation, suggesting the need to strengthen institutional capacity and promote inter-agency information-sharing and coordination. Because the decision to operate formally is taken using a cost-benefit lens including both the direct and indirect costs facing firms, it will be important to address business environment considerations that go beyond traditional incentive regimes.
REFERENCES


Annex Figure 1: Income tax plus employee and employer social security contributions (SSC) as a percentage of labor costs in OECD countries, 2014

### Annex Table 1: Evidence of employment and wage effects of changes in payroll taxes

<table>
<thead>
<tr>
<th>Author(s); year</th>
<th>Countries</th>
<th>Impact</th>
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</thead>
<tbody>
<tr>
<td>Antón, 2014</td>
<td>Colombia, tax code reform in 2012</td>
<td>As a result of a 13.5 percentage point decrease in non-wage labor costs, total employment would increase by between 0.3 to 0.5 percent and formal employment by between 3.4 to 3.7 percent over the pre-reform scenario. Formal wage rates would increase by 4.9 percent as a result of the reform.</td>
</tr>
<tr>
<td>Bassanini and Duval, 2006</td>
<td>OECD countries</td>
<td>On average, it is estimated that a 10 percentage point reduction in the tax wedge, a 10 percentage point reduction of unemployment benefits and/or a decline in product market regulation by two standard deviations would be associated with a drop in the unemployment rate by about 2.8, 1.2 and 0.7 percentage points, respectively.</td>
</tr>
<tr>
<td>Bell et al., 2002</td>
<td>UK, the 1999 reform in National Insurance Contributions (NIC)</td>
<td>The reform shifted the tax burden from low-wage to high-wage earners. A 1 percentage point rise in the NICs share is predicted to reduce nominal pay growth by around 1.4 percentage points after a year, while producer prices in the manufacturing sector rise by around 1.3 percentage points. Also, it led to a rise in employment growth of 0.5 percentage points, but the employment effect is statistically insignificant.</td>
</tr>
<tr>
<td>Betcherman and Pagés, 2009</td>
<td>Turkey, reform in pension contributions</td>
<td>An across-the-board reduction of 5 percentage points in pension contributions paid by employers would bring about a 0.8 percent increase in employment overall, and would reduce the unemployment rate by about 0.2–0.3 percentage points.</td>
</tr>
<tr>
<td>Cruces et al., 2010</td>
<td>Argentina</td>
<td>Changes in payroll tax rates are only partially shifted onto wages, with estimates ranging between 0.4 and 0.9 percent per percentage-point reduction in the tax rate, with the absence of any significant effect on employment.</td>
</tr>
<tr>
<td>Daveri and Tabellini, 1997</td>
<td>Industrial countries</td>
<td>For one group of countries (Scandinavia, Canada, US, Japan, UK (post-1980)), taxes have no significant impact on employment but for another group (Australia, Belgium, France, Germany, Italy, The Netherlands, Spain and UK (pre-1980)), the effects are substantial.</td>
</tr>
<tr>
<td>Daveri and G. Tabellini, 2000</td>
<td>EU countries</td>
<td>The observed rise of 14 percentage points in labor tax rates between 1965 and 1995 in the EU could account for a rise in EU unemployment of roughly 4 percentage points, a reduction of the investment share of output of about 3 percentage points, and a growth slowdown of about 0.4 percentage points a year. No effects for a subsample of Anglo-Saxon and Nordic countries.</td>
</tr>
<tr>
<td>Galasso, Ravaillon, and Salvia, 2001</td>
<td>Proempleo, a wage subsidy scheme targeted to workers in temporary employment in Argentina</td>
<td>Effects were only statistically significant among women and youth.</td>
</tr>
<tr>
<td>Heckman and Pages, 2004</td>
<td>Latin America</td>
<td>A 10 percent increase in payroll taxes decreases employment by 4.5 percent in selected Latin American countries.</td>
</tr>
<tr>
<td>Góra et al., 2006</td>
<td>A sample of 27 OECD countries for two years (1997 and 2003)</td>
<td>The tax wedge has a statistically significant and strong negative effect on the employment rate of unskilled prime-age male workers, but no effect on skilled workers.</td>
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<tr>
<td>Author</td>
<td>Country/Region</td>
<td>Description</td>
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<tr>
<td>Gruber, 1997</td>
<td>Chile over the period 1979-1986.</td>
<td>A change in payroll taxes in Chile reduced the average payroll tax rate from 30 percent to 5 percent over a six-year period. The incidence of payroll taxation is fully on wages with little impact on employment levels.</td>
</tr>
<tr>
<td>Katz, 1998</td>
<td>USA</td>
<td>A 15 percent reduction in labor costs because of the Targeted Jobs Tax Credit yielded a net employment effect of 7.7 percent; under the assumption of an infinitely elastic labor supply, this implies an elasticity of labor demand of -0.5.</td>
</tr>
<tr>
<td>Kugler et al., 2002</td>
<td>Labor market reform of 1997 in Spain</td>
<td>Reduction in payroll taxes led to an increase in permanent employment for young workers and older workers by 2.6 and 2.1 percent, respectively.</td>
</tr>
<tr>
<td>Kugler and Kugler, 2003</td>
<td>Colombia</td>
<td>The 10 percent increase of payroll taxes in the late 1980s and early 1990s resulted in a 1.4-2.3 percent decrease in net wages and a 4-5 percent reduction in formal employment.</td>
</tr>
<tr>
<td>Mühlau and Salverda, 2000</td>
<td>The Netherlands</td>
<td>The study found no employment effects of SPAK, a Dutch program to reduce taxes and social security contributions paid by employers for workers with wages around the minimum wages.</td>
</tr>
<tr>
<td>Nickell and Layard, 1999</td>
<td>Advanced countries</td>
<td>A one percentage increase in real labor cost in response to a one percentage point rise in the tax wedge between 0 percent in Austria and New Zealand to 1.6 percent in Belgium, and 1.4 percent in Ireland and Switzerland. No important differential tax effects on unemployment, but there is evidence that overall labor tax rates do influence labor costs in the long run and hence raise unemployment.</td>
</tr>
<tr>
<td>Rutkowski, 2007</td>
<td>ECA countries</td>
<td>A one percentage point change in the tax wedge results in a 0.3-0.6 percent change in the employment rate.</td>
</tr>
<tr>
<td>World Bank, 2005</td>
<td>EU8 countries</td>
<td>For a given GDP growth rate, each percentage point difference in the tax wedge is associated with a decrease in employment growth by 0.5 - 0.8 percentage points.</td>
</tr>
</tbody>
</table>
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