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Formal informality: informal practices of formal firms as a key business constraint



FORMAL INFORMALITY:

INFORMAL PRACTICES OF FORMAL FIRMS AS A KEY BUSINESS CONSTRAINT

Overview¹

Despite strong economic growth in recent decades led by the resource-based sectors, Lao PDR faces significant challenges, including high poverty rates and limited productivity. A highly challenging business and investment environment continues to hamper stronger private sector-led growth, especially outside the natural resource sectors, where job creation could be larger. In the still largely unreformed business and trade environment, the World Bank's 2016 Enterprise Survey identified "practices of firms in the informal sector" as the biggest problem reported by firms in the country, and addressing these and other challenges fundamentally will be critical to generate inclusive growth.

Based on interviews with business owners and top managers, this note finds that there are four main types of problematic informality in Lao PDR's business environment: inadequately registered enterprises that "fly under the radar"; widespread tax evasion; irregular adherence to complex and burdensome regulations; and a culture of noncompliance with basic rules and standards. Fully registered and formalized firms incur higher costs and feel unfairly targeted by authorities who are eager to collect revenue and fulfil their mandates. Unregistered or rule-evading competitors are alleged to escape the same level of scrutiny, due to the difficulty of enforcement and prevalence of petty corruption.

Tackling problematic informality in the business environment will require stronger institutions and a continued government focus on eliminating petty corruption. In the near-term, this note recommends eliminating unnecessary regulations and streamlining others by leveraging public support for transparency and consistency in the tax and regulatory systems. This should be complemented by a functional, efficient one-stop window for enterprise registration in order to encourage formalization. Putting these recommendations into practice will require improved monitoring, evaluation, and assessment practices based on reliable and timely common data.

Background

Lao PDR has seen tremendous economic growth in recent decades, with gross domestic product (GDP) expanding at an average of 8% annually since the year 2000. This growth has coincided with a shift from an agrarian to an increasingly natural resource-based economy, e.g., through mining and hydropower. However, while gross national income (GNI) per capita reached US \$2,150 in 2016 (up from US \$280 in 2000), poverty has been less responsive to economic growth in Lao PDR compared to other countries in the region, and creation of productive jobs has been limited.²

Strong natural resource-based economic growth has occurred despite a highly challenging business environment for the private sector, with Lao PDR ranked 139th out of 190 economies in the World Bank Group's 2017 Ease of Doing Business ranking. The poor business environment has contributed to limited job creation in non-resource sectors, which are critical to generating employment and entrepreneurial opportunities that will help Lao PDR achieve its targeted graduation from Least Developed Country (LDC) status by 2020.

To better understand the issues that firms face in doing business, the World Bank Group conducts Enterprise Surveys in countries around the world providing firm-level data on countries' business environments. Enterprise Surveys collect data face-to-face from a representative sample of a country's formal, non-agricultural private sector using a standard global methodology. The findings inform the design of policies and regulations that promote efficiency and growth in the private sector. This includes reforms that support inclusive growth and key development goals such as poverty reduction and robust private sector employment. In 2016, the World Bank

¹ This note was prepared by Anders Imboden and Mombert Hoppe with valuable assistance from the Lao PDR Ministry of Industry and Commerce and the Lao National Chamber of Commerce and Industry.

² World Bank (2017), Lao PDR Systematic Country Diagnostic, Washington, DC.

Group published its fourth Enterprise Survey for Lao PDR based on interviews with 368 firms in the manufacturing, retail, and service sectors across the country.

A key finding of the 2016 Enterprise Survey in Lao PDR was that businesses perceive “practices of firms in the informal sector” as a serious constraint on their operations. 77% of surveyed firms claimed to compete against unregistered or informal firms; 40% of surveyed firms described informality as a serious problem; and 27% (a plurality) identified informality as the biggest problem they face.³ There was no statistically significant correlation between variables like firm size, sector, or location, and firms identifying informality as a serious problem or the biggest problem they face, indicating that this issue affects all types of registered firms in the country. Other relevant findings from the Enterprise Survey include the prevalence of giving gifts in exchange for government contracts, permits, or to “get things done,” as well as a high rate of face-to-face meetings with tax officials far exceeding regional and global averages.

While the 2016 Enterprise Survey points to informality as a major issue, it does not include a mechanism to clarify which “practices of firms in the informal sector” are most problematic to survey respondents. There is also no precise definition of “the informal sector,” allowing respondents to interpret this term differently. Therefore, the World Bank Group requested a more detailed qualitative assessment to illustrate what firms mean when they point to “practices of firms in the informal sector” as an obstacle in Lao PDR, and to clarify the specific impacts of those informal activities or competitors.

Methodology

This assessment was based on a series of three focus group meetings with Lao and international firms. The focus group format allowed for a facilitated conversation among firm representatives, with a level of conviviality that encouraged open, honest discussion in response to guiding questions. Focus groups also provided practical benefits in terms of scheduling, securing firms’ participation, and obtaining an adequate sample size.

The Lao National Chamber of Commerce and Industry (LNCCI) acted as co-organizer and played a pivotal role in this assessment by identifying and inviting participants, as well as providing meeting facilities for the focus groups. The general composition of the focus groups is shown in Table 1. The first two focus groups were conducted in both English and Lao languages; the third and final focus group was conducted only in English, as participants represented foreign firms and chambers of commerce. In total, 21 business owners, top managers, or representatives participated. These firms did not necessarily participate in the 2016 Enterprise Survey (participating firms are not identified in the Enterprise Survey for confidentiality reasons). Focus group participants were invited by LNCCI based on their knowledge of and concern about the issue of informality in the private sector in Lao PDR. All firms who attended the focus groups are formally registered with authorities; similarly, 96% of firms participating in the Enterprise Survey are also formally registered. Given the Enterprise Survey’s lack of statistically significant differences amongst firms identifying “informal sector” practices as a problem, no special preference was given to any particular sector or business type in designing the focus groups.

Table 1: Focus Group Composition

	Focus Group 1	Focus Group 2	Focus Group 3
Date	12 July 2017	13 July 2017	14 July 2017
Participants	10 (6 men, 4 women)	5 (4 men, 1 woman)	6 (4 men, 2 women)
Theme	SMEs	Sectoral associations	Foreign businesses
Sectors	Retail/Wholesale Garments Professional Services Information Technology Real Estate Pharmaceuticals Agriculture	Tourism Retail/Wholesale Pharmaceuticals Printing	N/A ⁴

Each focus group was presented with the same introductory information on the relevant findings of the Enterprise Survey and the purpose of the assessment. Common guiding questions were shown to each focus group. However, conversations were allowed to flow as openly as possible and informal follow-up questions

³ Information on the Enterprise Survey, including results and methodology, are available at <http://www.enterprisesurveys.org/data/exploreconomies/2016/lao-pdr>

⁴ Participants in this focus group represented the membership of their respective chambers of commerce or international business associations. The six participants represented four organizations from Europe and Asia.

(both from the facilitators and other participants) helped to elucidate unclear points or comments of particular interest. Participants' responses were recorded via detailed written notes and synthesized for use in this report. For confidentiality purposes, participants' names or firms are not identified here.

Findings

The following two subsections—outlining types of informality that operators perceive as problematic in the Lao business environment, and assessing their impacts on other, more rule-abiding firms—highlight the key findings of this assessment. The findings are based primarily on the responses of focus group participants, and reflect firm owners' and managers' perceptions of informality's impacts on their business operations.

Problematic Types of Informality

Globally, the concept of informality in the business environment can refer to a range of practices, institutional arrangements, or transactions that are somehow hidden—at least in part—from authorities that would tax, measure, or otherwise regulate them were they not obscured.⁵ The 2016 Enterprise Survey identified “practices of firms in the informal sector” as a serious constraint on firms' business operations without specifying further what exactly respondents meant. To better understand what enterprises are concerned with in this regard, this section summarizes the common types of informality described by focus group participants as being most problematic in the business environment in Lao PDR.⁶ These are inadequate business registration; tax evasion; avoidance of complex and burdensome regulations; and a broader culture of noncompliance. While these issues are widespread, they are especially disruptive to the business environment when practiced by relatively larger firms.

Inadequate business registration

Focus group participants raised inadequate business registration as a key informal practice presenting a constraint to their operations. The participants indicated that most fully “formal” enterprises need to go through a registration process managed by the Enterprise Registry Office (ERO) of the Ministry of Industry and Commerce (MoIC). Many firms, particularly smaller ones, ignore this process, instead coming to a simpler arrangement with village or district authorities. Some firms may not register with any government entity at all. Unregistered firms allegedly avoid regular scrutiny from regulators and tax officials; even when known to authorities, owners or managers may be hard to track down.

Foreign firms are frequently said to do business in Lao PDR without registering in the country, bypassing the direct costs of registration and providing little information regarding their financial performance, labor arrangements, and other key information. Own-account (self-employed) workers are often completely unregistered, avoiding government scrutiny and taxes, while competing with registered firms in sectors like professional services, real estate brokerage, and retail (a worsening problem as social media allows for own-account workers to directly reach customers). And even when registered with the ERO, a firm may engage in business activities outside of their authorized scope of business. For example, taxis or vans in popular tourist areas often also provide tour services without authorization from the local tourism office or without membership in the relevant sectoral association, bypassing rules for registered tourism operators.

Many firms avoid the registration process because of its complexity. Formal registration requires obtaining many signatures and stamps from officials who may be slow to perform these services or who enforce additional unwritten, off-the-book, or valid but poorly-communicated rules. Well-intentioned officials may still need to work up the hierarchy to obtain signatures or approvals from higher-ranking colleagues, many of whom are not readily available due to meetings, travel, and other commitments. An important caveat: focus group participants mostly agreed that small family businesses serving primarily local needs (e.g., a small sundry shop attached to a home) do not present a major problem regardless of their registration status, and this type of informality is therefore likely not driving the results of the Enterprise Survey. Globally, these kinds of firms are often excluded from studies of informality due to their non-marketability.

Tax evasion

Tax evasion is another prevalent type of informality raised as generating challenges in Lao PDR. Firms may reduce their tax burden through underreporting of revenue; negotiating a lump sum tax payment not strictly based on revenue and sometimes paid to individuals, rather than the state coffers; or simply avoiding interaction

⁵ Andrews, D., A. Caldera Sánchez and Å. Johansson (2011), “Towards a Better Understanding of the Informal Economy”, OECD Economics Department Working Papers, No. 873, OECD Publishing.

⁶ The blanket term “informality” is used throughout this assessment, encompassing both firm characteristics and practices that focus group participants identified as “informal” in some way.

with the tax office altogether. The economy in Lao PDR remains cash- and paper-based, creating many opportunities to misrepresent the value or nature of transactions. This is the case across the range of taxes, from value added tax (VAT) to customs duties.

Avoiding complex and cumbersome regulations

Focus group participants also pointed to uneven adherence to complex and wide-reaching regulations that add little value. An example is the set of rules dictating a company's signage, which can quickly become a headache requiring time and financial resources to resolve. In this example, firm owners and operators must work with a number of separate offices within the Ministry of Information, Culture, and Tourism (MICT) to ensure compliance with detailed content and design rules, in addition to paying a number of fees. Meanwhile, other firms bypass this process entirely, with few consequences, whether due to personal connections, under-the-table arrangements with officials, or a lack of enforcement.

Broader culture of noncompliance

Other issues raised in the focus groups could be referred to as indicating a culture of noncompliance – for example, false advertising, failure to adhere to laws on consumer protection, and illegal hiring of foreign labor. These specific issues were attributed disproportionately to firms owned and operated by foreigners, especially from neighboring countries including China and Vietnam. Whether this is empirically the case is unclear, but participants' grievances with these businesses links to their frustrations with uneven enforcement of regulations and laws, whereby these foreign-owned firms are said to escape the same level of scrutiny as local firms. However, focus group participants also acknowledged that the officers tasked with enforcing regulations and laws on a day-to-day basis—whether on behalf of a line ministry or the police—have a difficult time interacting and communicating with foreigners who may not speak Lao fluently and have inherently different verbal and non-verbal communication styles. To observers, it may look like a different set of rules is applied to these foreign firms, while in reality, the problem lies at least partially in enforcement capacity.

Effects of Informality on Other Firms

As part of the focus group discussions, participants were asked to elaborate on the impacts of informality on their businesses. The participants offered both general observations and specific examples of how they are placed at a competitive disadvantage by informality. The following paragraphs review and synthesize the key points of discussion.

Underlying many firms' concerns about informal enterprises or informal business practices is the issue of fairness. Fully registered firms that attempt to report income, pay taxes, and conduct their business in accordance with laws and regulations are effectively placing a target on their backs by inviting closer scrutiny by authorities, while at the same time navigating a complex, burdensome web of regulations. This produces unfair outcomes.

To collect government revenue, governments frequently focus on those firms that are more transparent and compliant (i.e., highly formal) first, and Lao PDR is no exception. Setting the effectiveness of such an approach aside, this practice nonetheless adds to the disparities between firms that are highly formal and those that are not: holding all other factors equal, a firm that maintains its registration and pays its full tax bill in accordance with the law will have smaller margins than firms that do not. Raising prices to compensate for this difference in margin drives customers to those same competitors who are not collecting or paying taxes in full. Recording and reporting sales also creates an administrative burden for SMEs without robust accounting systems, resulting in labor or opportunity costs that non-compliant businesses do not have (and exacerbating the informal firms' profit margin advantage). Authorities have recently provided many SMEs with logbooks to keep track of sales, which the firms are then expected to use. While keeping book of sales is important—for example for firms to improve access to finance—this practice is also cumbersome, and more importantly, inherently unfair if informal firms avoid the requirement and requirements are not meaningful to facilitating access to finance with banks.

By avoiding taxes and regulations, informal firms can undercut more rule-abiding enterprises on price, driving up their market share at the expense of registered, tax-paying businesses. Firms in the focus groups felt that this has a range of effects on the broader market. In both retail/wholesale and services, product and service quality has allegedly suffered as a result of this “race to the bottom” on price. Focus group participants claimed that consumer demand for affordability creates perverse incentives that has led to unscrupulous false advertising, importation and sale of unregulated or uncontrolled products (including food and pharmaceuticals), and disregard for existing consumer protection rules. There is a belief that unregistered firms or firms that are engaging in informal practices are more willing to ignore consumer safety or advertising regulations. In principle, competition in the marketplace appears to be widely appreciated by businesses large and small, but the rules

governing this competition remain loosely enforced – creating an uneven playing field that makes legal and regulatory compliance a tremendous handicap on firms across many sectors.

Businesses are quick to emphasize the societal impacts of this situation. They highlight not only foregone revenue for the government, but also the “national shame” that reflects a long-term problem of unambiguous corruption and inadequate rule of law (a grievance exacerbated by the perception that many foreign firms escape the same level of scrutiny). Informality is a symptom of a system that has historically benefited individuals in opportune positions at the expense of both the state and broader society, and in that sense, cannot be tackled without also taking on these entrenched interests. There is hope in the Government of Lao PDR’s (GoL) ongoing efforts to establish a state firmly based on rule of law by 2020 and recent efforts to curtail rent-seeking by government officials. But high-profile crackdowns are not enough, as the issue of informality has been on the policy agenda for years without businesses seeing substantial improvement at the working level where petty corruption—a key enabling factor in avoiding registration, taxation, and regulatory compliance—is most likely to flourish. One focus group participant likened the current situation to a game of soccer without a referee. In this game, the players know the rules, but it is simply too easy to cheat and get away with it, creating an unfair match where those who follow all the rules have no chance of winning.

Recommendations

Each focus group concluded with a facilitated discussion about potential solutions to the prevalence and challenges associated with informality in the business sector in Lao PDR. In this manner, business owners and operators who acutely feel the effects of informal practices could influence broader policy conversations on the topic. Participants agreed that there is no “silver bullet” or single intervention that will eradicate informal business practices or firms, but were somewhat divided on whether to focus on radical vs. incremental change. For Lao PDR to achieve its LDC graduation and rule of law goals by 2020, a more predictable and fair business environment will be a critical pre-condition, and an important contributor to achieving both goals within the same timeframe. With that in mind, the following recommendations highlight incremental strategies to achieve a healthier private sector less burdened by informality. They are organized into **core recommendations** that target specific manifestations of informality in the Lao PDR business environment, and **supplemental recommendations** that can help make reforms a success. Both sets of recommendations are summarized in Table 2 and elaborated upon in the following section.

Table 2: Recommendations

Core Recommendations	
Type of informality generating obstacles to other businesses	Recommendation
<i>Inadequate business registration</i>	Prioritize a functional and efficient “one-stop window” for registration
<i>Tax evasion</i>	Strengthen the tax system to ensure transparency and consistency
<i>Avoiding complex and cumbersome regulations</i>	Eliminate unnecessary regulations and streamline others wherever possible
<i>Broader culture of noncompliance</i>	Build public awareness of, and support for, appropriate business regulations
Supplemental Recommendations	
Improve monitoring, evaluation, and analysis of current regulations and enacted reforms	
Share and use reliable, up-to-date data	

Core Recommendations

These recommendations specifically respond to the apparent difficulty of enterprise registration; the prevalence of tax evasion; the web of complex regulations that are unevenly applied; and the prevailing culture of noncompliance.

Prioritize a functional and efficient “one-stop window” for registration

Registering a business with the central government can be challenging, especially for SMEs. An oft-repeated joke about Lao PDR’s “one-stop window” business registration is that “stop” is the only part that is working so far. Making it easier to register a business and with the tax authorities will help to formalize those companies

that currently remain informal. To the extent that steps and requirements can be removed, they should be. Processes should be simplified and focus on effectively achieving clear policy objectives, and to ensure compliance with regulatory procedures on the government's side. As part of reviewing regulations, there is a need to clarify each agency's role and responsibilities – and to help front-line officials understand the broader process as well so that they provide firms with accurate and up-to-date guidance. On a more philosophical level, training should emphasize agencies' role as facilitators of investment and national economic development, rather than “gatekeepers.”

Strengthen the tax system to ensure transparency and consistency

The current tax system is essentially negotiation-based, rather than accurately reflecting and taxing firms based on their actual turnover. Stricter documentation and bookkeeping requirements can improve transparency and consistency for the GoL and business owners alike, particularly if coupled with meaningful penalties for noncompliance or fraud, particularly if these are implemented in ways that avoid penalizing formalization. New reporting requirements should be linked with efforts to increase the business registration rate, since uneven application of the rules creates a competitive advantage to unregistered firms. These efforts should be complemented by support for electronic bookkeeping, digital payments, and other technological improvements that help reduce opportunities for petty corruption or lengthy meetings between tax authorities and business owners.

Eliminate unnecessary regulations and streamline others wherever possible

In Lao PDR, firms must navigate an intricate web of rules and regulations that do not necessarily provide public benefits commensurate with the transaction costs associated with meeting or enforcing them. Firms, especially SMEs, often feel they have an impossible choice: to continue to engage in at least some informal activities despite the unpredictability this creates, or to register, pay their full tax obligations, and comply with all regulations – and potentially go bankrupt as a result. An independent assessment of each ministry and sector's regulatory programs could help in identifying specific rules that disproportionately consume authorities' and businesses' human and financial resources without meaningfully protecting public wellbeing. Some regulations may be well-intentioned but unnecessarily cumbersome: an example from this assessment is the signage for registered enterprises, which must follow strict content and design standards (to the point of dictating the color of the text and background). In practice, these standards are rarely enforced in full, opening the door to selective enforcement and petty corruption, which often target “low-hanging fruit” like registered firms that may only be slightly out of compliance. Authorities would be wise to consider simpler rules that allow for entrepreneurial creativity, while reserving enforcement for egregious violations of basic standards. This would produce an important co-benefit by improving perceptions of fairness in the business environment.

Build public awareness of, and support for, appropriate business regulations

Existing regulations on business registration, taxation, and operations require buy-in from the public to be successfully enforced in the long term. Some regulations surely need to be streamlined or eliminated, as suggested above – but in general, public accountability is crucial for government to collect revenue to provide core services, or to enforce rules that protect consumer safety or promote investment. For consumers to use their purchasing power as a tool to discourage informality requires steering consumer preference towards firms, products, and services that are compliant with government standards. This task will be made easier if regulations are not unnecessarily burdensome and are firmly rooted in the public interest. More broadly, the public should hold businesses and officials accountable by reporting informal firms or practices to authorities (including through existing hotlines, the effectiveness of which should continue to be improved). Chambers of commerce and sectoral associations are well-positioned to play a central role in these efforts.

Supplemental Recommendations

These supplemental recommendations do not respond directly to the issues identified by focus group participants. Rather, they suggest ways to make the core recommendations a success. These recommendations also reflect skepticism among focus group participants that enforcement of existing rules and regulations can be strengthened without better accountability for the ministries or agencies in question, both internally and to the Government and the National Assembly.

Improve monitoring, evaluation, and analysis of current regulations and enacted reforms

Many reform initiatives aimed at spurring private sector development in Lao PDR have been pursued through laws, decrees, and institutional restructuring. However, a persistent challenge has been a lack of consistent and transparent implementation of these rules, due in part to capacity constraints but also due to a lack of effective

monitoring of implementation at the working level.⁷ Monitoring and evaluation (M&E) of how rules and regulations are applied in practice, including monitoring regulatory compliance as well as costs and delays of regulatory processes, should identify priority areas for government attention, or existing rules and processes that are costly and provide little value or impact. This makes M&E a useful mechanism in increasing regulatory predictability and consistency, and undertaking the kinds of regulatory reforms identified in the core recommendations. Embedding a culture of routine M&E may also improve agencies' ability to track regulatory compliance within their own portfolio and assess how effective such regulations are in achieving policy outcomes.

Share and use reliable, up-to-date data

Good data is a basic requirement for meaningful M&E, but also for regulatory enforcement, revenue collection, and business development. Data collection and management is continually improving in Lao PDR, but many datasets are not shared between ministries or departments. Often this creates an inefficient demand for collecting identical data multiple times, as regulations are frequently justified through “statistical requirements” although the same data has already been collected elsewhere. The central government should use its authority to ensure timely sharing of existing and new data across agencies (e.g., for comparing business registration, trade, licensing, and tax collection data).

Conclusion

Firm owners and managers have made it clear that informality is a multi-faceted challenge with far-reaching impacts on how they conduct business. This qualitative assessment channeled the perceptions and experiences of the private sector in Lao PDR, based on spirited discussion with 21 business owners, managers, and representatives from a range of sectors and firm sizes. They highlighted persistent issues including inadequate registration, tax evasion, complex and unevenly enforced regulations, and a culture of noncompliance. Intertwined with these problems are a broader set of development challenges, including eliminating corruption, building up human resources, and firmly embedding the rule of law at all levels of society. While the government has already started to address some of these challenges, this note outlines key recommendations that can help to reduce the negative impact that various types of informality create, as outlined in the 2016 Enterprise Survey data. Improving the business environment remains critical to empower the private sector to generate the sustained and inclusive growth and job creation that Lao PDR requires.

⁷ See also OECD (2016), “Economic Outlook for Southeast Asia, China and India 2016: Enhancing Regional Ties”, which includes a helpful commentary on the business environment in Lao PDR from a policy perspective.