

private sector

The Informality Trap

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This Note is based on data from World Bank enterprise surveys on the investment climate. Available online at <http://rru.worldbank.org/InvestmentClimate/>, the data cover nearly 60 countries and span government policies, infrastructure, finance, and innovation. The data provide measures of productivity and performance and can therefore help track the results of investment climate reforms over time.



Tax Evasion, Finance, and Productivity in Brazil

This Note highlights the adverse consequences of informality for private sector development and explains what governments can do about it. It uses new data from the World Bank's Investment Climate Survey in Brazil that show for the first time the extent of tax evasion and confirm that informal firms are less productive and less likely to access financial markets than other firms. It also provides some advice on how to tackle the problem—by emphasizing the benefits of regulatory compliance, reducing the costs of going formal, and tightening up enforcement.

Informality means different things to different people. Sometimes the term is used to refer to tax evasion, and sometimes to other forms of regulatory evasion, such as noncompliance with labor and product standards. Whichever definition is used, informality is a serious problem in many developing countries. It is a particular problem in Brazil. According to an authoritative measure developed by Friedrich Schneider (2005), a professor at the University of Linz, informal activity accounted for 42 percent of Brazil's output in 2002–03, compared with 16 percent of China's, 26 percent of India's, and 33 percent of Mexico's.

This Note focuses on firms that are avoiding their tax obligations, generally by failing to declare all their sales or all their workers. Tax evasion is not the only reason so many Brazilian firms remain informal—noncompliance with labor regulations is a large part of the story—but

it is an important one. According to the World Bank's Doing Business survey for 2006, firms in Brazil must spend more time to comply with tax requirements than those in any other country. Brazilian firms are also more likely to cite tax administration as a severe constraint on their operations than their counterparts elsewhere. Tax evasion is also an area in which the Brazilian government has begun to make some progress, and its experience offers some lessons for policymakers in other developing countries.

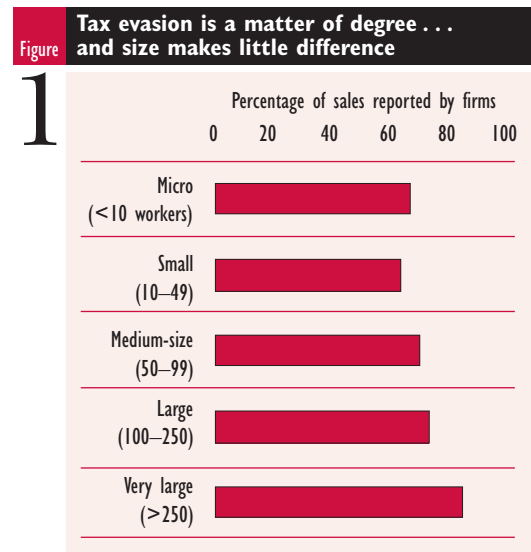
Why does informality matter?

Informality matters for several reasons. Probably the most serious one is that it stifles investment and undermines the overall competitiveness of the economy, because many informal enterprises are stuck in a low-productivity trap (Palmade and Anayiotos

2005). Being outside the regulatory and tax umbrella means that these enterprises can afford to be less productive than their competitors in the formal sector. But it also means that they are locked out of markets for finance, technology, and other resources that would enable them to close the gap. As a recent Brazilian government report puts it, “the informal economy . . . undermines the evaluation of credit risk by banks, raises the cost of borrowing and curtails the use of capital market instruments, where transparency is a necessary condition for efficiency” (Rocca 2004, p. 24). Of the 6,000 or so Brazilian companies with more than 250 workers, only 120 are listed and regularly traded on the São Paulo stock exchange.

The effects of informality on firm behavior emerge very clearly from the results of the World Bank’s Investment Climate Survey in Brazil. The 2003 survey covered more than 1,600 firms in a broad range of manufacturing activities. Because obtaining direct information about tax evasion is almost impossible (respondents are usually unwilling to acknowledge it), the survey asked firms what fraction of sales “a typical establishment in their area of activity” would report for tax purposes. This indicator serves as a proxy for a firm’s own level of compliance. The resulting data set provides the first hard evidence for Brazil on the extent of tax evasion and its costs:

- Tax evasion is not limited to small and medium-size enterprises, as is commonly believed (figure 1). Even large and very large firms, those employing more than 100 workers, reported only moderate compliance. Less than a third said that typical firms declared all their sales for tax purposes.
- Evasion is also a matter of degree—there are few outright saints or sinners. On average, respondents said that typical firms reported about two-thirds of their sales to the authorities. Compliance is higher in capital-intensive industries like chemicals and electronics than in labor-intensive ones like clothing and food processing.
- Firms that reported high levels of tax evasion also find it harder to access external finance and are less likely to be publicly listed. This is because selling shares to outside investors requires an external audit. Many of these



Source: World Bank, Investment Climate Survey, Brazil, 2003.

firms are unwilling to publish accurate information about their sales and profitability for fear of alerting the tax authorities.

- Firms reporting high levels of tax evasion are less productive than their formal competitors, even when size, ownership type, and other factors are controlled for. According to a recent World Bank study, a 1 percent increase in the share of informal full-time employees among Brazilian firms is associated with a 0.3 percent decrease in total factor productivity, with other factors constant (Reis forthcoming).

What is the solution?

Informality matters because it deters investment and productivity growth. But what can be done about it? Unfortunately, governments often worsen the situation by adding to the tax and regulatory burden to compensate for poor enforcement. This simply drives more firms underground. Breaking the cycle requires a careful approach that induces firms to comply with their obligations yet avoids driving them out of business. Moreover, policymakers need to recognize that eliminating informality can carry a high short-term cost. Simply closing down informal firms will throw many unskilled and poorly paid employees out of work, most of them beyond the reach of social safety nets. The best approach is to balance the carrot of partic-

ipation in formal institutions with the stick of stiffer penalties for persistent noncompliance.

Lessons from Brazil

In 2004 the Brazilian government put tax reform high on its political agenda. At the same time an influential study appeared that emphasized the role of unfair competition in undermining productivity and investment (McKinsey & Company 2004). This led policymakers to realize that tackling informality and extending the tax base were necessary to stimulate growth and improve the efficiency of the economy. The Brazilian case provides some concrete examples of what can be done.

Emphasize the carrot

Most important, policymakers need to convince firms that it is in their interests to go formal. Not only are informal firms shut out from markets for finance and technology; they also are more at risk from predation by public officials and less likely to participate in other formal institutions such as the courts. The Investment Climate Survey data for Brazil show that informal firms have less confidence that the judicial system will uphold their property rights in the event of a dispute, have less influence over the content of government regulations that affect their business, and are more likely to suffer from demands for bribes by corrupt officials. (Again, these findings hold even with firm size and ownership type controlled for.)

Policymakers should publicize these facts. The Brazilian government has done less along these lines than it might. Most examples of best practice come from other parts of the world, including industrial countries. The Peruvian Institute for Liberty and Democracy has elaborated guidelines for communicating with firms in the informal economy, understanding the barriers to formalization, and emphasizing the benefits of compliance. Business associations and similar representative groups can play a useful role in this communication effort, as they have in parts of northern Italy. Another possibility is to put in place transitional measures to encourage firms to come in from the cold. At the very least, newly compliant firms should be exempt from retroactive taxation.

Policymakers also need to reduce the burden of regulation. They should remember that tax compliance is not the only reason that firms remain informal. Registration and other procedural costs also matter, as do excessively rigid labor laws. Some countries, like the Russian Federation and Ukraine, have reduced informality by setting up one-stop shops for a range of government administrative requirements. Even so, reducing corporate tax rates and simplifying the paperwork for tax compliance certainly help.

The Brazilian Congress is considering a bill that would cut the number of state-level sales tax bands from 50 to 5. As with many other broad changes to the tax code, however, this bill has been held up by political deadlock between the federal and state governments. Another, more successful attempt to improve the tax environment for Brazilian firms is the SIMPLES program, introduced in 1997.¹ Targeted at small and medium-size enterprises, SIMPLES has shifted the tax burden away from payroll and profits and toward sales, and has unified many federal taxes. Popular among businesses, the program has noticeably boosted the creation of jobs in the formal sector, and the current government is considering extending it.

But keep hold of the stick

Tackling informality also requires governments to pay more attention to enforcement. This means stiffer penalties for noncompliance. In industrial countries fines for tax evasion are usually two or three times the taxes owed; in Brazil they are much lower (Farrell 2004). Detecting and punishing evaders also requires more resources. Brazil still spends only a small fraction of what most industrial countries spend on tax collection; it also lacks lawyers and judges with tax expertise (McKinsey & Company 2004). Remedying this will take many years.

Another requirement for improving tax enforcement is to change attitudes among businesspeople and the public. Here the Brazilian government has made some progress, delivering a short, sharp shock by jailing several prominent offenders. In July 2005 it arrested the owner of the country's second largest brewer for tax fraud, along with his brother, uncle, and two

cousins. The same month it closed down São Paulo's best-known luxury goods retailer for failing to pay duty on imported Italian shoes and handbags—all to send the message that nobody can count on impunity.

Policymakers also need to target firms that are using informality to gain a competitive edge. In Brazil some industries, like banking, telecommunications, and steel production, are well integrated into the formal economy; others, such as construction, retailing, and many other labor-intensive services, are not (McKinsey & Company 2004). The poorly integrated sectors are also dominated by smaller firms. These firms require a very different compliance strategy than larger ones—which is why many industrial countries have separate tax administration units for small and large firms. The Brazilian government has made an effort to identify the types of small business activity most prone to evasion, like gasoline and cigarette retailing. This information can help policymakers devise appropriate responses, since any strategy needs to be tailored to the characteristics of the industry it addresses. In Brazil, for example, the federal government was able to crack down on beer manufacturers by installing devices that measure the flow of liquid through the production line and report output levels electronically to the Internal Revenue.

Finally, detecting evaders requires great coordination and information sharing among government departments, particularly the tax authorities and police. It also calls for close collaboration between the government and the legitimate private businesses that suffer from the effects of unfair competition. This is important because tax evasion is less visible and harder to track than many other types of crime. In 2004 Brazil established a National Antipiracy Council with members from seven government departments and private sector representatives. This has allowed more cooperation among the Federal Police, Internal Revenue, and customs authorities and has led to several large-scale joint policing operations. One result has been to cut smuggling along the Paraguayan border by 30 percent. Another has been to increase the value of contraband seized in the country by almost half.

Conclusion

Informality impedes private sector development by undermining investment and productivity growth. Contrary to what many people have argued, informal firms do not always “grow up” and join the formal sector. Instead, they can remain stuck in an informality trap, excluded from markets for finance and forced to evade taxes and other regulations to compete with their more productive rivals. The solution lies in a mix of stronger incentives for compliance and stiffer penalties for noncompliance.

Note

1. For more information on SIMPLES (Integrated System for Payment of Taxes and Contributions by Micro and Small Enterprises), including a survey of entrepreneurs on its effectiveness, see <http://www.sebrae.com.br/br/parasuaempresa/conhecaosimples.asp>.

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