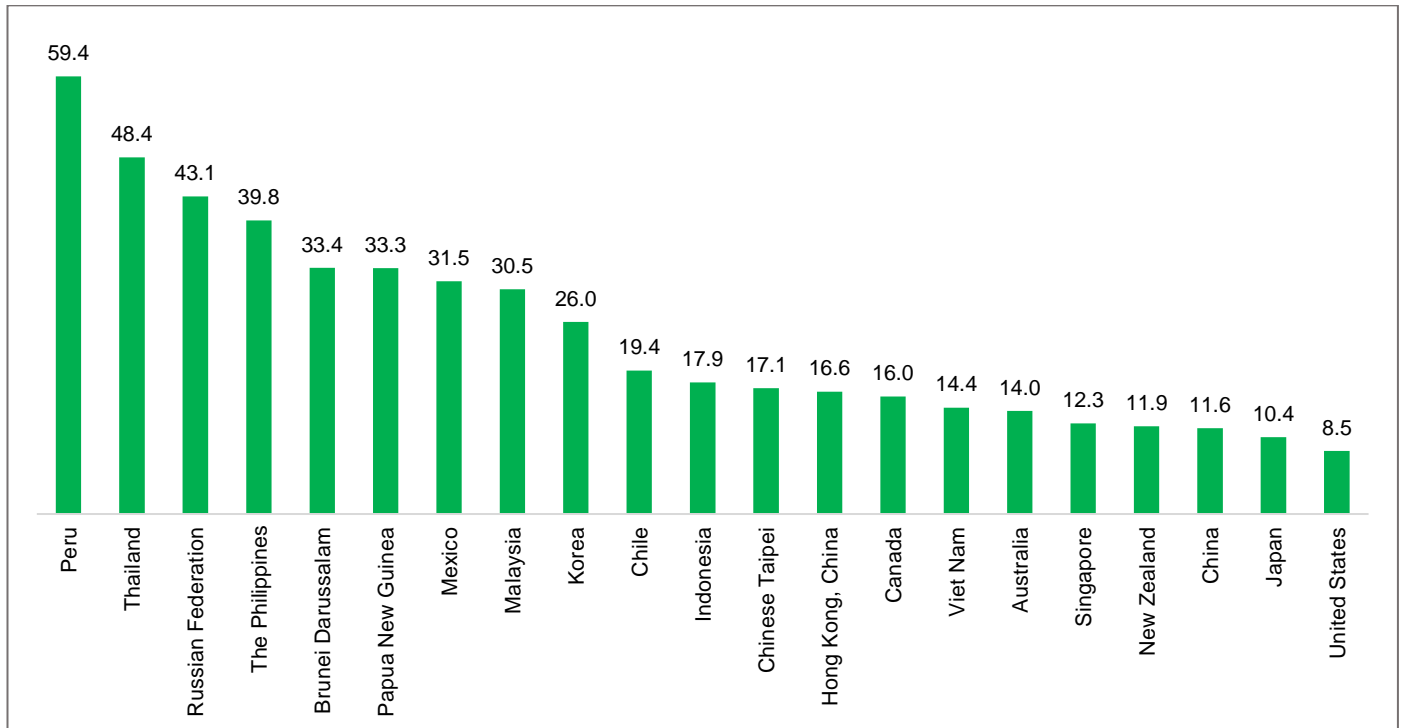


# Addressing Informality: Transitioning to the Formal Economy

By Carlos Kuriyama and Eldo Malba Simanjuntak

## KEY MESSAGES

- Informality has long been a problem globally, though the factors driving informality are not the same for every economy. Bureaucratic barriers, deficiencies in developing human capital and weak institutions are some of the major factors underlying the presence of informality. These factors are often linked to subsistence issues, low productivity, socioeconomic vulnerability, and poverty. Unfair competition, tax evasion and lack of compliance to rules are also common in informal economies.
- Transitioning to the formal economy is therefore important in helping to address the variety of socioeconomic issues facing economies.
- To encourage formalisation, policymakers should seek to ensure that the benefits of participating in the formal economy are greater than any benefit derived from remaining in the informal economy.
- Given the multidimensional nature of informality, a mix of policies should be considered, and policymakers need to identify which mix is best suited to addressing the specific underlying causes of informality in their own economy.
- Creating a suitable regulatory atmosphere that facilitates businesses could encourage firms and workers to participate in the formal economy. Interventions should go beyond reducing time and cost of paperwork, and may include reforming tax and social security systems, as well as introducing flexibility in labour markets.
- Measures to improve governance and institutional quality, fight against corruption and fix deficiencies in rule enforcement may also facilitate a transition to the formal economy.
- Incentives are important. Governments have to ensure that the delivery of public services is efficient and effective, so that taxpayers can see the tangible benefits of participating in the formal economy.
- Likewise, enhancing human capital through education and training are needed to improve workforce productivity and ensure that workers gain the necessary skills to improve their chances of moving into the formal economy.



**Figure 1. Estimates of informal output in 2020 (% of GDP)**

Note: Data for Hong Kong, China; and Chinese Taipei are estimated by APEC Policy Support Unit (PSU) staff using the methodology in Elgin et al. Source: C. Elgin et al., “Understanding Informality,” CERP Discussion Paper 16497, Centre for Economic Policy Research, London, 2021.

## Introduction

According to the International Labour Organization (ILO), the informal economy refers to ‘all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements’.<sup>1</sup>

Informality occurs around the world, with different nuances and varying dimensions across economies. Informal work is the predominant source of livelihood for poor individuals and other disadvantaged groups in society. The ILO has estimated that 6 out of 10 workers – or about 2 billion individuals – are working informally.<sup>2</sup> This is even more pronounced in low and lower-middle income economies, where the overall prevalence rate

could rise to more than 80 percent,<sup>2</sup> with informal economic activities representing on average about 35 percent of the gross domestic product (GDP) of each economy.<sup>3</sup>

Informality remains pervasive in many APEC economies. The size of the informal economy in the APEC region has been estimated at around 13.4 percent of GDP in 2020, with a high of 59.4 percent in Peru and a low of 8.5 percent in the US (Figure 1).<sup>4</sup> In addition, informal employment in the seven APEC economies that do have such data ranges from 25 to 80 percent of the workers in the economy.<sup>5</sup> The high level of informality hinders the progress toward sustainable

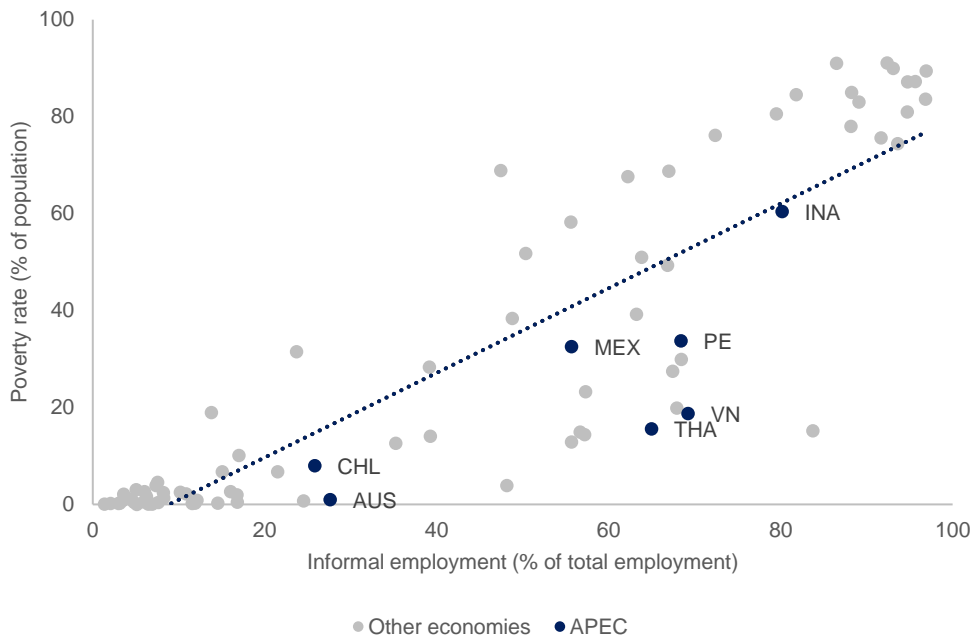
<sup>1</sup> International Labour Organization (ILO), “Informal Economy and Atypical Forms of Employment,” accessed 8 February 2024, [https://www.ilo.org/actrav/areas/WCMS\\_DOC\\_ATR\\_ARE\\_INF\\_EN/la ng--en/index.htm](https://www.ilo.org/actrav/areas/WCMS_DOC_ATR_ARE_INF_EN/la ng--en/index.htm)

<sup>2</sup> ILO, “World Employment and Social Outlook: Trends 2023” (Geneva: ILO, 2023).

<sup>3</sup> International Monetary Fund (IMF), “Five Things to Know about the Informal Economy,” 28 July 2021, <https://www.imf.org/en/News/Articles/2021/07/28/na-072821-five-things-to-know-about-the-informal-economy#:~:text=The%20informal%20economy%20is%20a%20glob al%20phenomenon%2C%20but%20there%20is,15%20percent%20i n%20advanced%20economies>

<sup>4</sup> The APEC-wide estimate was calculated by APEC Policy Support Unit (PSU) staff based on economy-level estimates in C. Elgin et al., “Understanding Informality,” CERP Discussion Paper 16497, Centre for Economic Policy Research, London, 2021.

<sup>5</sup> C. Elgin et al., “Understanding Informality.”



**Figure 2. Informal employment and poverty rates (2018–2022)**

AUS=Australia; CHL=Chile; INA=Indonesia; MEX=Mexico; PE=Peru; THA=Thailand; VN=Viet Nam

Note: Poverty rates are measured using the international poverty line of USD 6.25 per day in 2017 purchasing power parity (PPP). Only economies with available data in the covered period of 2018 to 2022 are shown.

Data for each economy is from the latest period with available data. Source: C. Elgin et al., “Understanding Informality,” CERP Discussion Paper 16497, Centre for Economic Policy Research, London, 2021; World Bank Poverty and Inequality Platform, accessed 8 February 2024, <https://pip.worldbank.org/home>

development. For instance, the lack of legal and social protection for informal workers makes them more vulnerable.

This policy brief highlights the root causes of informality, and discusses what is required at the policy level to address informality and promote a proper transition to the formal economy.

## Why is informality associated with negative socioeconomic implications?

### Informal employment correlates with higher poverty levels

Figure 2 shows that economies with higher informal employment usually have a larger proportion of their population living in poverty. Informal employment is often lowly paid. The median earnings of informal workers in several APEC economies are around 40 to 67 percent lower than those working formally.<sup>6</sup> Yet, for

many workers, informal employment is the only form of work available. Where a significant share of the population lacks access to stable employment, poverty and inequality can be exacerbated.<sup>7</sup>

### Informal workers are insufficiently, or not covered, by social safety nets

Access to healthcare insurance, public housing and social assistance are usually tied to formal employment as these benefits are financed by contributions from employees (deducted from wages), employers (based on legal mandates) or a mix of both. Having social security benefits could lessen the effect of economic shocks on workers.

However, informal workers lack these social safety nets. That, together with the reality that, traditionally, they have lower and more fluctuating income, renders them more susceptible to external shocks. A 2021 survey of over 2,000 informal workers in 11 cities around the world found that only 41 percent of the respondents had

<sup>6</sup> Based on available data from five APEC economies. OECD, “Formal to Informal Worker Hourly Earning Ratio (Ratio of Median Hourly Earning),” OECD.Stat, accessed 11 October 2023, [https://stats.oecd.org/Index.aspx?datasetcode=KIIBIH\\_B1](https://stats.oecd.org/Index.aspx?datasetcode=KIIBIH_B1)

<sup>7</sup> A.M. Oviedo, M.R. Thomas, and K. Karakurum-Özdemir, “Economic Informality: Causes, Costs, and Policies – A Literature Survey,” World Bank Working Paper 167, World Bank, Washington DC, 2009.

access to cash transfers from governments during the COVID-19 pandemic, and only 42 percent received food aid.<sup>8</sup>

## Informal economic activities are associated with fewer opportunities to expand

Informal businesses are typically small in size, require just a handful of workers, and are mostly run for subsistence purposes, with few able to grow and innovate. They also face difficulties meeting the requirements for obtaining credit from financial institutions to expand their businesses. All these factors contribute to lower productivity. Informal labour productivity has been estimated to be about 79 percent lower than formal labour productivity in a sample of 18 developing economies worldwide (Table 1).

## Informality implies a narrower tax base and revenue loss

Pervasive informality implies that a large share of transactions are unreported, affecting tax revenue, and depriving governments of sufficient resources to deliver public goods and services. Thus, informal workers and businesses represent untapped revenue sources.

It is estimated that potential tax revenue equivalent to 5.4 percent of GDP is lost from informal practices in the APEC region, and these losses could reach more than 9 percent of GDP in economies with high incidence of informality.<sup>9</sup> Globally, about USD 3 trillion or 5 percent of global GDP is lost from tax evasion due to informality.<sup>10</sup>

When informality is high, formal workers and firms bear a larger share of the tax burden, creating (adverse) incentives for formal taxpayers to also avoid paying taxes because they see little benefit in being compliant.

## Factors explaining the presence of informality

Informality is a phenomenon that cannot be exclusively associated with a particular sector, place or socioeconomic level. It occurs everywhere and it has several dimensions (for example, age, sex, sector, socioeconomic conditions, geographic area).

The reasons for staying in the informal economy are diverse. In some cases, informality is related to

<sup>8</sup> Martha Chen et al., "COVID-19 and Informal Work: Distinct Pathways of Impact and Recovery in 11 Cities around the World," WIEGO Working Paper 42, May 2021, Women in Informal Employment: Globalizing and Organizing (WIEGO), Manchester, 2021, 28.

<sup>9</sup> APEC PSU staff calculation for the 13 APEC economies for which data are available. The size of the informal economy is based on estimates from: Elgin et al., "Understanding Informality."

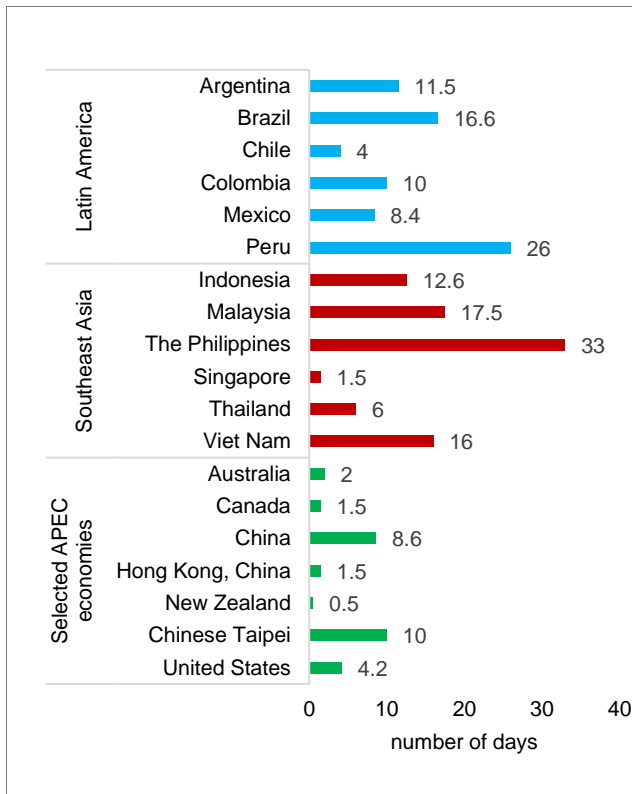
<sup>10</sup> P. van der Molen, "Informal Economies, State Finances and Surveyors," *Survey Review* 50, no. 358 (2018): 16–25, <https://www.tandfonline.com/doi/full/10.1080/00396265.2016.1216922>

Economy	Difference to formal firms <sup>a</sup> (%)
Angola	-75.5 ***
Argentina	-92.5 ***
Burkina Faso	-79.8 ***
Botswana	-89.8 ***
Côte d'Ivoire	-47.5 *
Cameroon	-55.8 ***
Congo, D.R.	10.7
Cabo Verde	0.89
Ghana	-51.8 ***
Guatemala	-86.0 ***
Kenya	-81.6 ***
Madagascar	-88.1 ***
Mali	-71.3 ***
Myanmar	-89.1 ***
Mauritius	-82.9 ***
Nepal	-56.5 ***
Peru	-74.2 ***
Rwanda	-91.4 ***
<b>All 18 economies</b>	<b>-79.4 ***</b>

**Table 1. Productivity difference between informal and formal firms in selected developing economies**

Note: <sup>a</sup>Differences in productivity are between the median formal and median informal firms in each economy. Asterisks indicate that the difference is statistically significant at either 1% (\*\*\*) or 10% (\*) level. Source: M. Amin, F.L. Ohnsorge, and C. Okou, *Casting a Shadow: Productivity of Formal Firms and Informality* (Washington, DC: World Bank, 2019).

subsistence-level earnings that do not allow for enough resources for the transition to formality. An example is subsistence farming by poor households who work on small land holdings producing just enough for their own



**Figure 3. Time spent to start a business, 2020**

Source: World Bank, "Doing Business," 2020, accessed 31 October 2023, <http://www.doingbusiness.org>

consumption. Another common example is street vendors doing business at near-subsistence levels.<sup>11</sup>

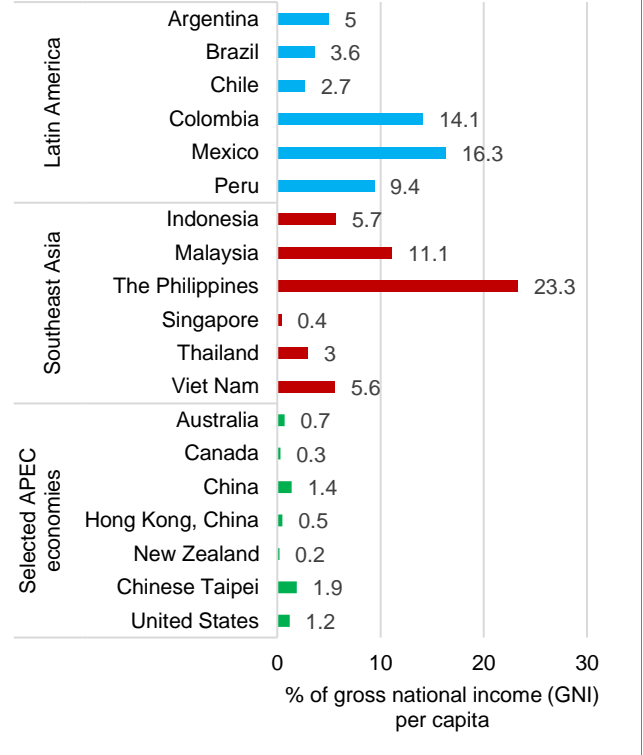
In other cases, individuals and firms have the resources to formalise, but they would only make the transition if the benefits of doing so outweigh that of remaining informal. Enhancing the attractiveness of the formal economy to these individuals and firms could involve regulatory and policy frameworks affecting the business environment, as well as institutional and social aspects. Some of these factors are explored in this section.

## Bureaucratic barriers

The cost and length of procedures and the difficulties associated with regulatory compliance could motivate individuals and firms to remain in the informal economy.<sup>12</sup> This occurs more often among micro, small and medium enterprises (MSMEs) and less-educated workers as scale and human capital issues could make them spend a considerable amount of time navigating through all the requirements.

For example, there is some amount of paperwork required before starting operations in the formal economy. Businesses have to initiate a registration

<sup>11</sup> R. La Porta, and A. Shleifer, "Informality and Development," *Journal of Economic Perspectives* 28, no. 3 (2014): 109–26.



**Figure 4. Cost of starting a business, 2020**

Source: World Bank, "Doing Business," 2020, accessed 31 October 2023, <http://www.doingbusiness.org>

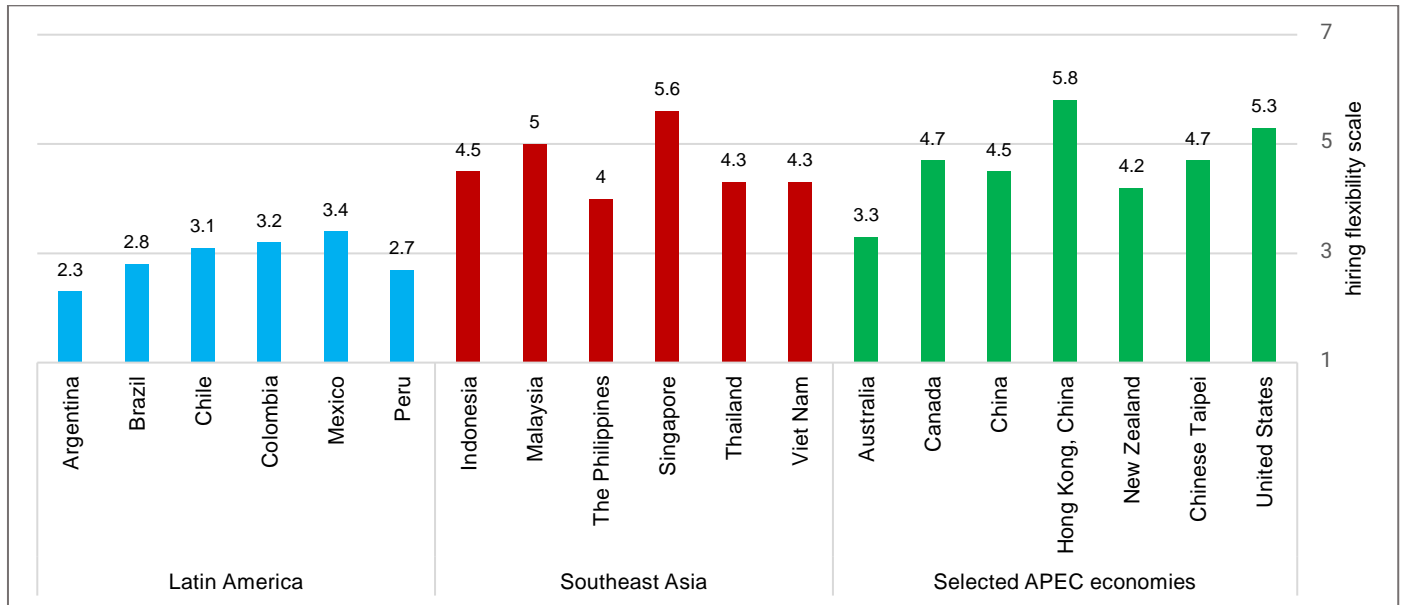
process to constitute a firm, make payments, apply for a tax number, obtain licenses and navigate other legal procedures. These procedures also involve non-tangible costs such as time spent to meet all the requirements. The higher the cost and the longer the time needed to formalise, the more the incentive to remain informal.

Latin America and Southeast Asia are two regions where informality rates are high and perform poorly with regard to time and cost to start a business (Figures 3 and 4 respectively). As noted earlier, excessive bureaucracy and complex regulatory matters mostly affect MSMEs, as they have fewer human and financial resources to deal with these issues.

Another bureaucratic issue preventing higher participation in the formal economy is lack of flexibility in the labour market. When labour regulations stipulate large statutory salary deductions for a number of reasons (for instance, social security contributions), many workers will prefer to stay off the payroll and remain informal.

Also, firms could consciously choose to stay informal if it is onerous to recruit formally and dismiss workers.

<sup>12</sup> S. Djankov et al., "The Regulation of Entry," *The Quarterly Journal of Economics* 117, no. 1 (2002): 1–37.



**Figure 5. Flexible hiring and dismissal of workers, 2019**

Note: Values shown summarise responses to the question 'to what extent do regulations allow for flexible hiring and firing of workers?' A value of 1 indicates 'not at all' while 7 indicates 'to a great extent'. Source: K. Schwab, ed., "The Global Competitiveness Report 2019" (Geneva: WEF, 2019).

Even formal firms could decide to hire workers informally when labour regulations make costly the process of hiring and dismissing a worker. Figure 5 shows that the largest Latin American economies experience inflexible labour regulations in comparison to most other economies in the sample. This coincides with high informality levels. Sometimes, regulations enacted to protect workers could have the detrimental effect of discouraging formal hiring due to the high cost of compliance.

## Human capital issues

Deficiencies in developing human capital could trigger informality. Informal employment could be the only source of work available to some workers because of their lack of proper qualifications and their lower productivity. At the individual level, informal workers tend to be less productive than formal employees working on similar tasks,<sup>13</sup> as they have fewer opportunities to access educational training and other resources.

In general, informality tends to be higher in places with lower educational attainment. For economies where adults have fewer average years of schooling than the APEC-wide average of 10.6 years,<sup>14</sup> the average size of their informal economy is 11 percentage points higher relative to the average for the rest of the APEC

economies. Similarly, the share of vulnerable employment is 31 percentage points higher in those economies.<sup>15</sup>

## Institutional issues

Problems related to respect for the rule of law and enforcement, rampant corruption and rent-seeking practices, when they are the norm, promote informality. The benefits of formalising are low when enforcement is poor, litigation is long, expensive and cumbersome, and expectations for the independence of the courts are minimal. Figure 6 shows a negative correlation between perception on judicial independence and informal output. The lower the confidence in the courts, the higher the informal output as a percentage of GDP.

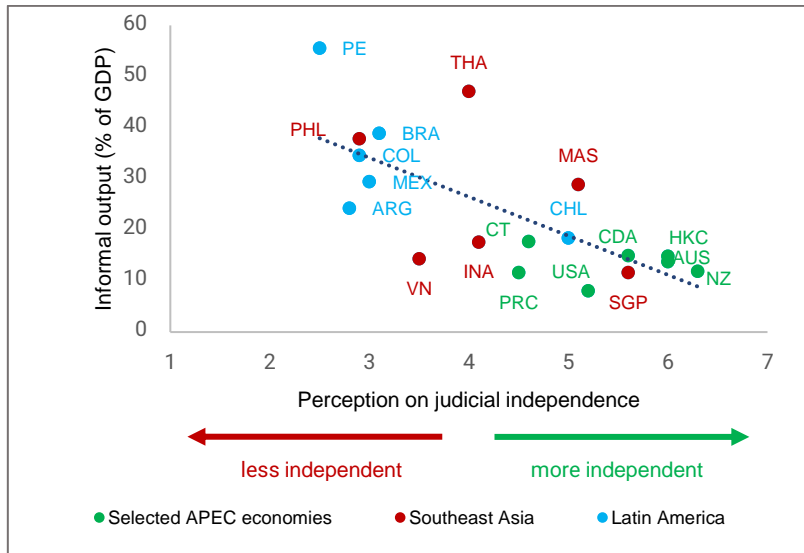
In addition, it is more difficult to convince informal actors to formalise when social cohesion is poor and societies have little trust in the government, private institutions and any type of networks/associations. An analysis using the Social Capital Index, which measures levels of trust and respect and the interactions of individuals with institutions, shows a direct association between social capital and informal output. Less socially cohesive economies tend to experience higher levels of informal output (Figure 7).

<sup>13</sup> Organisation for Economic Co-operation and Development (OECD), *Breaking the Vicious Circles of Informal Employment and Low-paying Work* (Paris: OECD Publishing, 2024), <https://doi.org/10.1787/f95c5a74-en>

<sup>14</sup> The estimates are from: R.J. Barro and J. Lee, *Education Matters: Global Schooling Gains from the 19th to the 21st Century* (New York: Oxford University Press, 2015).

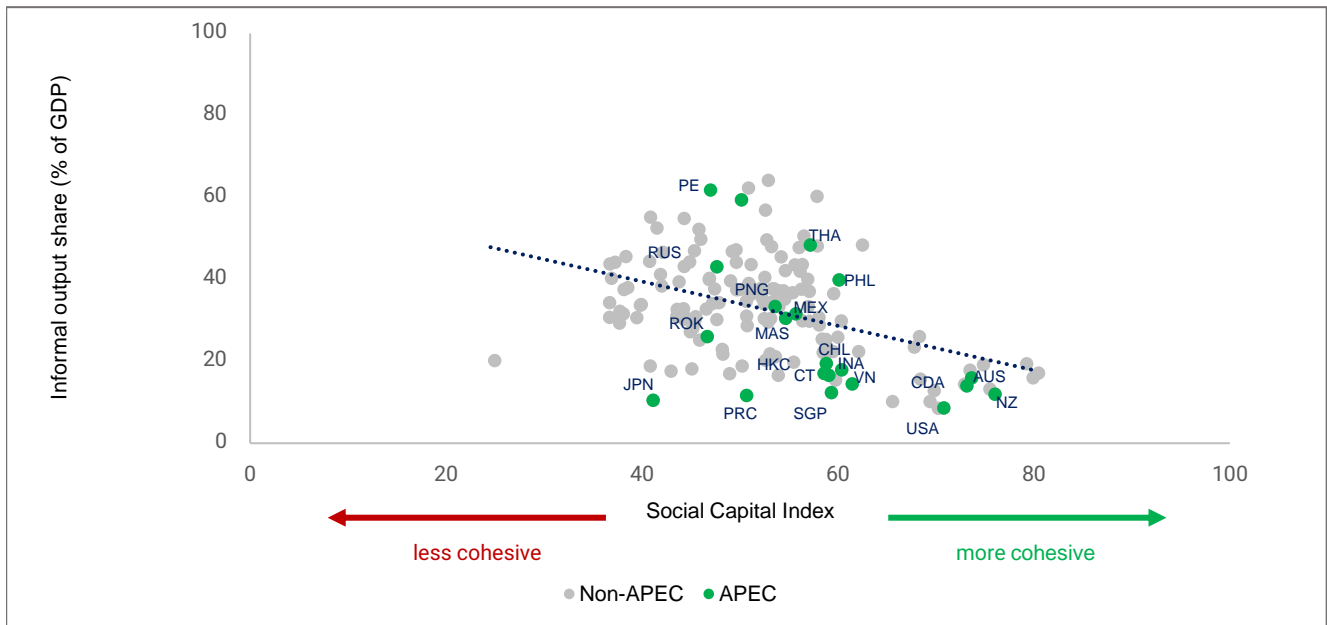
<sup>15</sup> Barro and Lee, *Education Matters*.





**Figure 6. Correlation between informal output and perception on judicial independence, 2019**

Note: Values for the ‘perception on judicial independence’ indicator summarise responses to the question ‘how independent is the judicial system from influences of the government, individuals, or companies?’ A value of 1 indicates ‘not independent at all’ while 7 indicates ‘entirely independent’. Source: K. Schwab, ed., “The Global Competitiveness Report 2019” (Geneva: WEF, 2019); C. Elgin et al., “Understanding Informality,” CERP Discussion Paper 16497, Centre for Economic Policy Research, London, 2021.



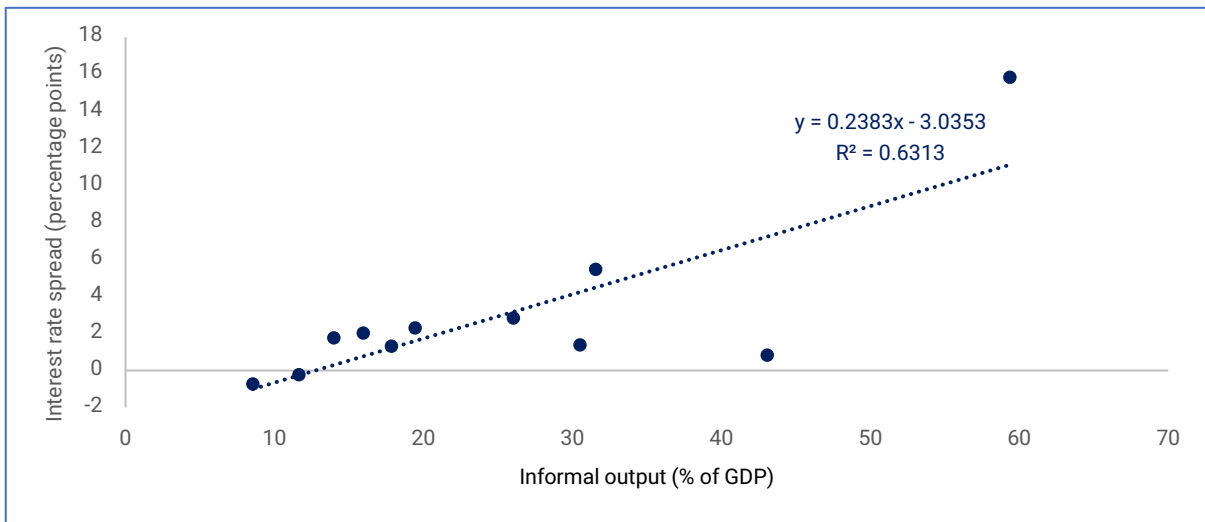
**Figure 7. Correlation between informal output and the Social Capital Index, 2020**

Note: The Social Capital Index measures the strength of personal and social relationships, institutional trust, social norms, and civic participation in an economy. Values range from 0 (least cohesive society) to 100 (most cohesive society). Source: C. Elgin et al., “Understanding Informality,” CERP Discussion Paper 16497, Centre for Economic Policy Research, London, 2021; The Legatum Institute, “The Legatum Prosperity Index 2023,” accessed 5 February 2024, <https://prosperity.com/about-prosperity/prosperity-index>

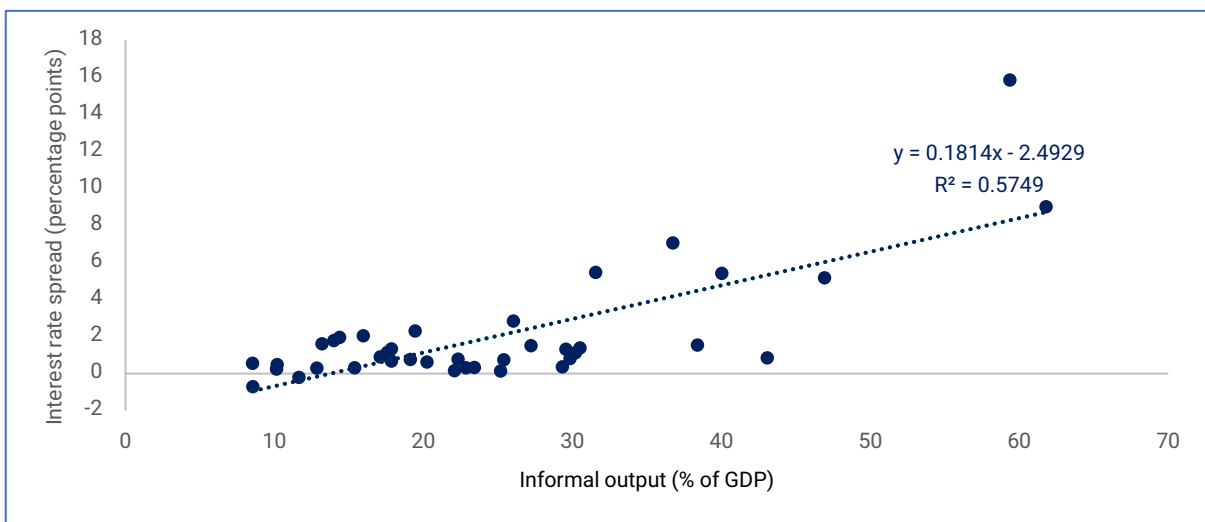
Figures 6 and 7:

(APEC economies) AUS=Australia; CDA=Canada; CHL=Chile; PRC=China; HKC=Hong Kong, China; INA=Indonesia; JPN=Japan; ROK=Korea; MAS=Malaysia; MEX=Mexico; NZ=New Zealand; PNG=Papua New Guinea; PE=Peru; PHL=the Philippines; RUS=Russia; SGP=Singapore; CT=Chinese Taipei; THA=Thailand; USA=United States; VN=Viet Nam  
 (Other economies) ARG=Argentina; BRA=Brazil; COL=Colombia

## (a) APEC economies



## (b) World



**Figure 8. Correlation between informal output and interest rate spread, 2020.**

Note: The interest rate spread is defined as the difference between the loan interest rate charged to small and medium enterprises (SMEs) and large firms. Source: C. Elgin et al., "Understanding Informality," CERP Discussion Paper 16497, Centre for Economic Policy Research, London, 2021; OECD, "Financing SMEs and Entrepreneurs: An OECD Scoreboard," OECD.Stat, accessed 29 January 2024, [https://stats.oecd.org/Index.aspx?DataSetCode=SMES\\_SCOREBOARD](https://stats.oecd.org/Index.aspx?DataSetCode=SMES_SCOREBOARD)

## What is required to promote formalisation?

### Creating an enabling environment for doing business

An enabling environment for doing business will make it easier for firms to work in the formal economy, create new jobs and foster entrepreneurship. Policies need to ensure that the conditions are in place for individuals and firms to have opportunities to thrive. This includes a

combination of measures at the local and central levels to reduce time and cost of doing business.

Enhancing the ease of doing business in a formal setting requires more than simply reducing registration fees. Attention should also be paid to eliminating cumbersome administrative procedures, which take up time and resources that could be used for other productive actions. Economic actors are more willing to formalise if the steps are simple, the compliance costs reasonable, and the benefits of participating in the formal economy are greater than the benefits of staying informal.



In other words, efforts to promote formalisation would be more effective if reducing the monetary cost to formalise is combined with simplification of the required paperwork. Within APEC, economies with pervasive informality have in place twice the number of procedures compared to other APEC member economies.<sup>16</sup> The relative cost to start a business in the APEC economies with pervasive informality is also on average 7 percentage points higher than the rest of the APEC economies.

Administratively, inter-institutional coordination is required to prevent repetition of tasks across different agencies. Many of the solutions generally involve integrating and digitising some of the functions of the relevant agencies.<sup>17</sup> One example is ChileAtiende, a one-stop shop that provides a multi-channel network for accessing public services. This initiative has reduced the time and cost to start a business: any person could constitute a firm in one day, at no cost, through submitting an electronic form.<sup>18</sup>

Another important enabling element is access to credit with reasonable conditions (particularly interest rates). To be successful, entrepreneurship projects require access to capital, which could help firms deal with the costs of formality. There is also a need to address the virtuous circle created due to formal firms being more likely to obtain bank loans at lower interest rates compared to informal businesses. Government policies need to establish conditions for a competitive financial sector that could offer affordable interest rates to borrowers, in particular, MSMEs.

Figure 8 shows a direct correlation between informal output and loan interest rate spread. The greater the difference between the loan interest rate charged to SMEs and large firms, the more the economy is likely to experience more persistent informality, because SMEs have less access to capital to participate in the formal economy.

Carefully designed tax and social security systems are also required to promote formalisation. When tax rates are excessively high, firms keep many of their operations informal to evade paying taxes. Similarly, when tax systems are cumbersome, compliance costs are high, reducing the incentives to participate in the formal economy. Tax systems need to be simple to promote formality. Multiple tax brackets with sharp

increases in tax rates as firm size grows would discourage firms from investing in expansion. Large firms would also not declare transactions so as to enjoy lower tax rates.

Policymakers should avoid introducing too many different schemes in a tax reform to cater for specific groups, as they may not necessarily stimulate formalisation. For example, there are three optional tax regimes in Peru for micro and small enterprises (as an alternative to the general tax regime) intended to promote formalisation. However, despite being well-intentioned, these schemes add confusion and have not been successful in stimulating widespread formalisation.<sup>19</sup>

Similarly, introducing flexibility in labour markets through reforms to reduce the barriers to hiring and dismissing workers formally is important and has to be accompanied with social safety nets to facilitate the reinsertion of workers into the economy.<sup>20</sup> Social protection policies are critical in the transition to formality, as has been recognised by the UN Inter-Agency Task Team for the Global Accelerator on Jobs and Social Protection for Just Transitions.<sup>21</sup> Ideally, these social security reforms should include universal basic coverage funded by general taxes, and complementary coverage funded through voluntary contributions.<sup>22</sup>

## Designing incentives and deterrents

Policymakers need to be aware that the exclusionary effect of barriers to conducting business is one of the main causes of pervasive informality. At the same time, they need to ensure that economic agents will not behave in ways that flout rules, disrupt order, disregard tax obligations and compete unfairly with those in the formal economy.

While solid enforcement and detection systems could increase the cost of remaining informal, a zero-tolerance approach to punish informality could be counterproductive. Severe enforcement may not reduce informality much; instead, it could force those in the informal sector deeper into the underground economy, with worse consequences, such as unemployment, drug or alcohol addiction, crime or insurrection.<sup>23</sup>

<sup>16</sup> World Bank, "Doing Business," 2020, accessed 31 October 2023, <http://www.doingbusiness.org>

<sup>17</sup> World Bank, "How Many Stops in a One-stop Shop? A Review of Recent Developments in Business Registration" (Washington, DC: World Bank, 2009).

<sup>18</sup> ChileAtiende, "Tu Empresa en un Día" [Your Company in a Day], 2023, <https://www.chileatiende.gob.cl/fichas/21409-tu-empresa-en-un-dia>

<sup>19</sup> IMF, "Peru: Technical Assistance Report – Tax Regime for Small Taxpayers and Special Economic Zones" (Washington DC: IMF, 2022).

<sup>20</sup> N. Loayza, "Informality: Why Is It So Widespread and How Can It Be Reduced?" (Washington, DC: World Bank, 2018).

<sup>21</sup> UN Global Accelerator on Jobs and Social Protection for Just Transitions (UN Global Accelerator), "Transition to Formality," 2023, [https://www.unglobalaccelerator.org/sites/default/files/2023-05/Roadmap\\_Transition%20to%20formality.pdf](https://www.unglobalaccelerator.org/sites/default/files/2023-05/Roadmap_Transition%20to%20formality.pdf)

<sup>22</sup> UN Global Accelerator, "Transition to Formality"; Loayza, "Informality."

<sup>23</sup> N. Loayza, "Addressing Informality" (Presentation at the *Symposium on APEC 2024 Priorities*, Lima, Peru, 4 December 2023), [http://mddb.apec.org/Documents/2023/SOM/ISOM-SYM/23\\_isom\\_sym\\_006.pdf](http://mddb.apec.org/Documents/2023/SOM/ISOM-SYM/23_isom_sym_006.pdf)

It is more advisable to focus on incentives such as accessibility to public services. For instance, when the population notices that taxes are being used judiciously, there is more incentive to comply with tax obligations.<sup>24</sup> Access to better education, good quality transportation systems, efficient police protection, improved public health systems and a fair judicial system strengthen the notion that tax revenue is being used properly, and individuals and firms will feel that they are reaping the benefits of paying taxes and complying with other legal obligations. According to evidence from the World Bank, measures to improve government services for SMEs and access to commercial and professional infrastructure have reduced the share of informal output in the economy.<sup>25</sup>

Changing people's mindset with small incentives could also contribute to reducing informal practices such as not declaring transactions or assets. For example, some Latin American economies, among them Argentina, Brazil, Colombia, Mexico and Paraguay, have implemented programmes to encourage consumers to request invoices that would allow them to participate in a prize draw.<sup>26</sup> In the Municipality of Santa Fe in Argentina, the city government announced a lottery for those who are timely with property tax payments, with 400 individuals awarded the construction of a sidewalk. They found that those who received the award were 7 percent more likely to pay their taxes on time for the next three years. Further, those with initial pending arrears were 7.5 percent more likely to pay their taxes on time if they had neighbours who received the award.<sup>27</sup>

## Enhancing human capital development through education and training

Access to proper education and training is an essential component to improve labour productivity and provides workers the necessary skills to obtain better-paid jobs and improve their chances to move into the formal economy.

A more accessible educational system reduces informality levels. According to a study by Haanwinckel and Soares, informality rates among workers fell by more than 10 percentage points between 2003 and

2012, most of which can be explained by the increased schooling during the same period.<sup>28</sup> In fact, the share of the Brazilian workforce with less than basic schooling (fewer than eight years of education) declined from 33.8 percent to 20.9 percent, while at the same time, those with college degrees represented 12.5 percent of the workforce in 2003 and 18.9 percent in 2012.<sup>29</sup>

Improvements in educational outcomes can reduce informal output. A World Bank study indicates that a 10-point increase in the Programme for International Student Assessment (PISA) reading score is associated with a fall in informal output by 0.1 percentage point of GDP over the next two years.<sup>30</sup>

Knowledge diffusion is an important pillar in driving up formalisation. For informal MSMEs and workers, one of the barriers to formalisation is their understanding of the formalisation process itself. Raising awareness through campaigns to educate the public about the benefits of transitioning to the formal economy and the obligation it carries could support government efforts to promote formalisation.

## Strengthening institutions

Institutions matter, as institutional failures bring more informality. Problems related to deficiencies in rule enforcement, corruption, weak governance and lack of transparency create the conditions for informality to expand. Resolving these issues are important steps to support the transition to formality. In fact, improvements in governance and institutional systems are associated with a decrease of informal output. A study by the International Monetary Fund (IMF) has shown that greater government accountability is associated with a smaller informal economy.<sup>31</sup>

A whole-of-government approach matters when addressing informality. The multifaceted nature of informality requires a combination of policy measures that often fall under the responsibility of a multiplicity of public institutions. Inter-institutional coordination is critical to designing and implementing an effective strategy to address informality holistically and guarantee a successful transition to formality.

<sup>24</sup> F. Ohnsorge, and S. Yu, eds, "The Long Shadow of Informality: Challenges and Policies" (Washington DC: World Bank, 2022), Ch. 6, <https://www.worldbank.org/en/research/publication/informal-economy>.

<sup>25</sup> Ohnsorge, and Yu, eds, "The Long Shadow of Informality." Improving government services support for small and medium enterprises (SMEs) by 1 standard deviation was followed by a 0.1-percentage-point decline in the share of output informality in five years. Likewise, a 1-standard-deviation improvement in SMEs' access to quality commercial and professional infrastructure reduced the informal output by a 0.1 percentage point in two years (p. 280).

<sup>26</sup> A. Collosa, "Best Practices to Encourage the Issuance of Invoices," Inter-American Center for Tax Administrations, 22 November 2023, <https://www.ciat.org/best-practices-to-encourage-the-issuance-of-invoices/?lang=en>

<sup>27</sup> P.E. Carrillo, E. Castro, and C. Scartascini, "Do Rewards Work? Evidence from the Randomization of Public Works," IDB Working Paper IDB-WP-794, Inter-American Development Bank, Washington, DC, 2017, <https://publications.iadb.org/en/do-rewards-work-evidence-randomization-public-works>

<sup>28</sup> D. Haanwinckel, and R.R. Soares, "Fighting Employment Informality with Schooling," *IZA World of Labor*, no. 394 (2017), <https://wol.iza.org/articles/fighting-employment-informality-with-schooling/long#izawol.394-figure-000003>

<sup>29</sup> Haanwinckel, and Soares, "Fighting Employment Informality."

<sup>30</sup> Ohnsorge, and Yu, eds, "The Long Shadow of Informality."

<sup>31</sup> H. Devine, "How Institutions Shape the Informal Economy," in *The Global Informal Workforce: Priorities for Inclusive Growth*, ed. C. Deléchat and L. Medina (Washington, DC: IMF, 2021), Ch. 8, <https://www.elibrary.imf.org/display/book/9781513575919/ch009.xml?tabs=fulltext>

## Final remarks

Informality is a multidimensional issue. The problem is complex with different underlying factors in different economies. There is no silver bullet to resolve this issue. While experiences in economies that have successfully transitioned to a more formal economy may provide some policy ideas, transition strategies cannot always be directly copied and require certain adjustments to local contexts.

Policymakers need to ensure that reforms would enable a proper business environment for economic growth that would encourage individuals and firms to transition to the formal economy. Solid institutional systems matter and a whole-of-government approach is needed to support these reforms. Furthermore, incentives need to be in place to ensure that the benefits of participating in the formal economy would be greater than any benefit from remaining informal. These policies will be effective as long as they include complementary measures to improve the provision of public services, including education, as the increased accessibility of those public services could convince the population of the benefits of being part of the formal economy.

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