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Policy Insights No. 81

October 2008

# Living with Duality: Fiscal Policy and Informality in Latin America

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**(Based on the OECD *Latin American Economic Outlook 2009*)**

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- Latin America's large informal sector is an indicator of a broken social contract.
- Simpler tax and benefit schemes for all – in the formal and informal sectors alike – will reduce the economic burden of informality while bolstering the legitimacy of Latin American fiscal systems.

Although hard to measure, informality is by all accounts high in Latin America: about half of the region's working population can be considered informal. In Mexico, the only Latin American country that belongs to the OECD, up to 60 per cent of non-agricultural workers – almost 22 million people – are employed informally or self-employed. These working people have opted out or have been shut out of the formal system of taxes and social protection. In that sense, they bear witness to a broken social contract between citizens and the state.

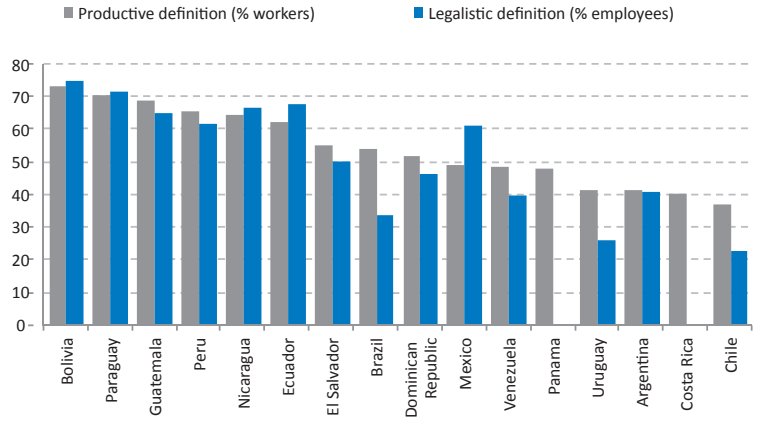
The OECD *Latin American Economic Outlook 2009* shows that the extent of the informal sector is intimately related to the fiscal system: employers and workers in the informal economy do not pay corporate or personal income taxes, nor do their customers generally pay any relevant sales taxes. Informality also affects public spending: informal workers are usually left out of social security. For instance, more than half of Latin American workers are not entitled to pension rights through their jobs and rely instead on personal savings, informal arrangements or social assistance in their old age.

Informality has a direct impact on public revenues and expenditures – the stuff of fiscal policy. As such, Latin American fiscal systems must grapple with the phenomenon. The first step is to recognise that informality arises for many reasons, and that the informal sector differs from one place to another. Some workers and companies stay out of the formal economy as a result of a deliberate choice based on a cost-benefit calculation. On the other hand, other economic actors – generally low productivity workers and micro-entrepreneurs – are in the informal sector as a result of exclusion from the formal economy: for them informality constitutes a survival strategy. In practice, all Latin American countries have both types of informality. As a result, the distributional effects of any policy aimed at reducing informality can be difficult to predict.

A comparison with Europe highlights the difference between undeclared work and undeclared workers, an important distinction for Latin America. In Europe, informal employment is to a large degree a matter of evasion of taxes and regulations, resulting in undeclared work by otherwise declared workers. In Latin America, in contrast, undeclared workers form a much larger share of the problem, with the added concern of their exclusion from social security coverage. This includes self-employed workers as well as those employed informally. It is notable that many firms in the region are not entirely formal or informal. It is therefore crucial not only to make formality more accessible, but more specifically to lower the cost of declaring and protecting workers.

While it is well-known that informal employment in the region is concentrated in small firms, there is no comparable body of evidence to suggest that the army of small and micro-enterprises is behind the bulk of tax evasion. In fact, many informal workers are too poor to pay taxes should their activity be formalised, hence their incorporation to the formal economy would not necessary mean an increase in tax collection. Therefore, the emphasis on "fighting" informality needs to be revised, together with the traditional vision of the informal sector as a set of illegal activities that need to be "formalised" due to the supposed drain they impose on public revenues.

Figure 1. **Labour Informality in Latin America**




*Note:* The productive definition of informality includes the unskilled self-employed workers, workers in small private firms of fewer than five employees, and workers receiving zero-income; the legalistic definition of informality refers to employees with no pension entitlement through their jobs.

*Source:* *Latin American Economic Outlook 2009,* OECD 2008.

Better enforcement is of course part of the equation, but Latin American fiscal systems should also better align the costs of formality with its benefits. Simplified regimes for some tax payers can go some way to incorporating small enterprises and their employees into the formal economy, but easing compliance for all tax payers is a far superior solution. The provision of social services to formal and informal workers on a more equal footing is likewise necessary. The challenge is to avoid reinforcing the existing formal/informal divide by creating a set of rights for insiders and a different one for those outside the formal fiscal system. Universal social protection can certainly encourage informal employment, but it can also help improve national productivity by promoting labour mobility – not to mention its positive impact on poverty reduction and the protection of vulnerable groups in the population.

Informality will probably go hand-in-hand with development in Latin America for years to come. In order to better account for this reality, Latin American fiscal regimes need to recognise the many shades of grey between formal and informal economic activity. If informality is a symptom of a broken social contract, then treating informal workers merely as outlaws simply reinforces the problem. Formality is not just a matter of following the rules. Formality must be recognised as the guarantee – not the precondition – of economic rights.



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