This brief was developed by the authors as part of the ELLA Programme. It was developed based on a Regional Evidence Paper *Informality and Inclusive Growth in Latin America: The Case of Colombia* by the same authors, which contains an overview of regional evidence, as well as original data collection and analysis, on a particular research topic. All publications can be found in the [ELLA programme website](https://www.ella-programme.org).
On the Doorstep of Formality: Different solutions for Different Informalities

The informal sector is not a homogeneous mass of individuals. The same instruments cannot be used to deal with the informality of a senior executive avoiding taxes or that of a street vendor.

Informality is a corrosive phenomenon for taxes, production, competitiveness, and society in general, but it is also the only livelihood option for some population groups. This report analyses how informality affects inclusive growth, studying informality by different socio-economic groups, and presents policy recommendations for each of these groups.

In the case of Colombia, informality is very heterogeneous so it must be addressed through various strategies ranging from better education in the poorest segments, to more flexible formal jobs, to the implementation of better monitoring and control of higher income independent workers. Faced with restrictions on entry into the formal sector in Colombia, we found that the reduction in 2013 in payroll taxes was a successful policy. However, further reductions in these contributions must consider their impact on tax collection, given the difficult fiscal situation in the country.

To reduce induced informality, it is important to design measures focused on controlling discriminatory behavior and on reducing formal employment barriers e.g. tax reduction on the 2012 payroll.

For countries with subsistence informality, the most favorable policies have been education policies.

Addressing voluntary informality requires reducing the incentives to be informal, making formal employment more flexible, and an increase in the monitoring and control of higher income self-employed workers.

The policies designed to reduce informality can be negative if they are not applied to the right informality type.

How does informality impact inclusive growth?

The research conducted by Fernandez and Villar (2016) seeks to establish the effect of informality on inclusive economic growth in Latin America, and particularly in Colombia. One of the main conclusions of this work is that the informal sector cannot be understood as comprising a homogeneous mass of people. The cited work identifies three distinct groups, based on explanations of their informality.
A Taxonomy of Informality

<table>
<thead>
<tr>
<th>Voluntary/ Involuntary</th>
<th>Subsistence</th>
<th>Induced</th>
<th>Voluntary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Productivity</strong></td>
<td>Involuntary due to low productivity</td>
<td>Involuntary due to barriers</td>
<td>Voluntary</td>
</tr>
<tr>
<td><strong>Barriers to formality</strong></td>
<td>Very low</td>
<td>Similar to formal</td>
<td>Regulatory barriers and/or discrimination</td>
</tr>
</tbody>
</table>

From the individual’s perspective, each one of these groups has a different relationship with the promotion of inclusive growth:

1. **Voluntary Informality**: Individuals who perform a cost-benefit analysis and decide to be informal (Voluntary Informality). This informality can be positive at the personal level, assuming that the cost-benefit analysis is properly conducted taking into account the long-term.

2. **Due to barriers to informality**: Individuals who are ready to participate in the formal labor market but cannot do so, due to the discrimination or regulatory barriers to informality (Induced Informality). In these cases, informality has a negative relationship with the promotion of inclusive growth because barriers prevent workers from operating in a more productive and safe environment.

3. **Due to low productivity**: Individuals who have low levels of education and work experience and/or work in low productivity cities/areas/sectors (Subsistence Informality). These workers have a low probability of finding a formal job, even if barriers to informality are significantly reduced. In this case, it is difficult to argue that informality is not positively related to inclusive growth - at least at the individual level and in the short-term.

Nonetheless, these individual decisions also entail some negative externalities at the societal level:

- Informal companies/workers make demands on public services without contributing to them.
- Companies/workers who do not pay taxes represent unfair competition to formal companies. According to the World Bank, 55% of Colombian companies report informal competitors’ practices as a restriction on their growth.
- Informal companies tend to be less productive because they keep production levels down, to avoid the authorities’ radar, and because of the restricted access to some services, including credit, copyright protection and the administration of justice.
• Informality increases corruption. According to a World Bank study, informal companies divert between 10% and 15% of their gross income to corruption, while formal companies divert about 1% of their gross income.

**Informality impact on inclusive growth**

<table>
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<tr>
<th></th>
<th>Positive</th>
<th>Negative</th>
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<tr>
<td></td>
<td>Individual</td>
<td>Society</td>
</tr>
<tr>
<td>Subsistence</td>
<td>Short-term</td>
<td>Short-term</td>
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<tr>
<td>Induced</td>
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<td>X</td>
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<tr>
<td>Voluntary</td>
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**Informality Structure in Colombia.**

*In line with the above, in order to analyze the effect of informality on inclusive growth, it is helpful to identify the level of participation of the different types of informality in the country. These groups are not easily identifiable because even a single worker may face three informality types simultaneously. However, with the help of some indicators, it is possible to estimate which informality types prevail in the country.*

*In the case of Colombia, 59% of self-employed informal workers and 60% of salaried informal workers would prefer to have a formal job either with the same or a lower salary. Similarly, 55% of self-employed informal workers report being informal because it is impossible to find a formal job. These percentages are high compared to other countries in the region (40% in Argentina, 26% in Bolivia and 25% in Dominican Republic, even though questions are not fully comparable). The above shows that most of the informal population in the country would rather have a formal job, i.e. they are involuntary informal workers. These workers can be segregated from the formal market due to low productivity i.e. low level of education and experience, or because they work work in less productive cities (subsistence informality) or due to barriers to enter the formal market (induced informality).*

*In order to identify the extent of the subsistence informality issue, we estimated the number of workers with productivity much lower than the cost of hiring in the formal sector (minimum wage plus non-wage costs). These workers would have a hard time finding jobs in the formal sector even if the barriers to enter the formal sector were reduced considerably. If productivity levels are equated to the wage levels earned in the informal sector, in Colombia 40% of workers show productivity below 50% of the hiring cost. In other words, they are Substistence Informal Workers*
Another indication of the importance of Subsistence Informality is the incidence of informality in workers with low levels of education, experience and/or working in less productive cities. According to the graph on the left, workers with primary education or less show an odds ratio of 2.9, which means that they are 2.9 times more likely to be informal than workers with primary and secondary education, (the ‘omitted category’). Also, workers over 45 years old and those living in less productive cities are more likely to be informal.

Workers with induced involuntary informality are segregated by discrimination and barriers to entry to the formal market. The informality indicators graph also shows that being a woman is an important factor in informality. Indeed, the informality rate is 52% in women and 46% in men even though the average levels of education and the expressed preference for formal jobs is very similar. In addition, the unemployment rate is 12% for women and 8% for men, which further corroborates evidence in favor of gender discrimination in the labour market. Also, there is evidence of race discrimination in Colombia: According to Bernal (2009), a worker from an ethnic minority is more likely to be an informal worker regardless of their education level.

However, Fernández et al (2016) argue that the greatest evidence of induced informality lies in the barriers for entry into the formal market. Despite the 2012 tax reform, which reduced payroll taxes paid by employers from 29.5% to 16% and replaced it with profit tax, the rate of payroll taxes on business profits in Colombia is still 18.6%, slightly above the world average of 16% (WDI, 2015). The relatively significant impact of reducing these taxes on informality, which reduced informality levels by close to 3% or 4% according to our estimates, confirms the extent of induced informality in Colombia.
Policy Implications.

- **Voluntary Informality** must be addressed by reducing the incentives to be informal e.g. making formal work more flexible, allowing for health and pensions plans, flexible hours and part-time workdays, but also by increasing control and inspections at high-income independent workers’ worksites.

- **Subsistence Involuntary Informality** must be addressed by increasing levels of education and/or skills. For instance, Brazil’s increased supply of skilled labour resulted in a ten-point reduction in the informality rate (Haanwinckel and Soares, 2014).

- **Induced Involuntary Informality** can be addressed by reducing the barriers to enter the formal market. Discrimination against women can be dealt with by controlling discriminatory behavior, through the provision of child care services in order to promote mothers’ work and affirmative action. Given the size of induced informality in the country, reducing payroll taxes was the right policy to reduce informality in a country such as Colombia.

Implementation of policy recommendations in a difficult economic environment.

The current difficult economic situation in Latin America and the complexity of the Colombian economic situation, after the dramatic drop in oil and coal prices, will probably result in more informality and less formal jobs. In these circumstances, it is relevant to ask how to promote the creation of formal jobs in time of significant fiscal restraint.

Given the heterogeneous structure of informality in Colombia, the issue must be addressed through several instruments, each oriented to a specific target group of informal workers. Increasing education levels is the most effective way to incorporate subsistence informality workers into the formal sector. While this is an intensive long-term resource investment, it should be noted that the education budget has been relatively immune to budget cuts.

As regards voluntary informality, we suggest increasing monitoring and control. However, this policy application must be very specific to avoid negative social effects on the vulnerable population whose livelihoods depend on informality or who have been excluded from the formal market. Introducing flexibility to pension mechanisms can also be a good strategy to loosen up barriers to enter the formal market. The government has been working on this issue by introducing ‘BEPS’, which offer the possibility of obtaining benefits similar to pensions, for people earning below minimum wage. However, these mechanisms need some adjustments.

Regarding subsistence and induced informality, we suggest reducing the barriers for entry to the formal market. Payroll tax reduction is difficult to implement in a
context of lower public sector revenues. However, in Colombia’s specific situation, a structural tax reform has been announced, aimed at reducing the tax burden on companies, thus increasing the tax burden on individuals. The reform proposed to the government by the Tax Think Tank Committee is going in this direction. This Committee also raises the possibility of further progress in reducing payroll parafiscal contributions, particularly those made to the Compensation Funds, taking into account their tax implications and workers’ welfare. Other policy options that contribute to reducing informality without significantly affecting public finances, include restoring the rural minimum wage, and zoning or regionalization of the general minimum wage.

References and Useful Resources.


Organization and Authors

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