



Department  
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Course of International Economics

# Informal Economy In Peru & Its Impact on GDP

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# INFORMAL ECONOMY IN PERU & ITS IMPACT ON GDP

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## **1. Introduction**

This study's goal is to reevaluate how Peru's informal economy affects the country's economic growth. The major reasons for the formation of the informal sector are income disparity, poverty, unemployment, economic growth, and economic crises. Other issues are more closely related to government over-regulation and a high tax load. There are many repercussions of this phenomenon, much like there are many causes. The effects of the informal economy on economic, social, and tax policies are highlighted: the more informal the economy, the less effective are social and economic policies. Additionally, a lower level of tax collection is made, which is impacted by both a lower tax base and lower tax compliance rates per person. The relationship between the informal economy and GDP has conflicting empirical support, depending on how the informal economy is measured. Recent estimates indicate Peru's informal economy accounts for 42.2% of the country's GDP or roughly \$270 billion in GDP PPP terms. The study is crucial because Peru's informal economy might seriously hinder the country's economic growth if it does not get under control. Alfredo Thorne, Peru's former finance minister, outlined an ambitious plan to shrink the informal economy in 2016, aiming to reduce it to 30% of the labor force by 2021. However, the plan includes many strong, comprehensive ideas, it falls short in certain critical areas. In order to address these problems, this paper offers policy recommendations that governments might use to regulate the unrecorded economy and ensure that it eventually converts to a documented or reported form.

This study is divided into 6 chapters i.e. Introduction, Informal Economy, Informal Economy in Peru, Impact of Informal Economy on Economic Growth and Conclusion. Introduction aims to introduce the purpose and components of this study to the audience. It is a relatively short chapter that includes a brief summary of each of the following chapters. The main objective of this chapter is to create a roadmap for its readers and to also allow readers to get the gist of the entire study.

The next chapter I.e. Informal Economy, in detail answers the question 'What is Informal economy?'. The informal economy includes a wide range of economic activities, businesses, employment, and employees that are not subject to state

regulation or protection. The term originally applied only to self-employment in small unregistered firms. It now also covers wage employment in unprotected jobs. This chapter overall covers all basic points that a person needs in order to understand the topic at hand. It includes some major facts about the informal economy. Further, it explains various views of informal economy followed by what causes it, what consequences it produces and how it is measured. It further states the link between informal economy and SDGs, environment, economy and social issues.

The chapter ‘informal economy in Peru’ focuses solely on Peru, its formal and informal economy, why it is important to study Peruvian informal economy, and what are its causes and consequences, what is the size of informal economy in Peru, what is the share of informal employment, etc.

The next chapter proceeds as impact of informal economy on the economic growth. First, it explains the general impact of informal economy on the economic growth which can be further divided into negative and positive impacts. Furthermore, it explains specifically the impact Peruvian informal economy has on its economic growth.

The policy recommendation chapter of this study acknowledges what positive or negative impact the informal economy has on economic growth and gives recommendations on what policies should be adapted in order to tackle these impacts of informal economy.

The last chapter concludes the entire study and its findings as; the pervasiveness of the informal economy in Peru necessitates immediate action to prevent the negative impacts on Peru's economic future. Reduced GDP growth, lost tax income, and lower national productivity can all stymie a rising economy. Myths persist, preventing Peru from addressing the informal sector. Peru must address its informal economy through comprehensive social and labor reforms that minimize impediments to formalization while also incentivize workers to engage formally. To better the lives of millions of inhabitants, Peru must integrate its people into the formal labor market, thereby investing in the country's economic future success.

The conclusion is finally followed by bibliography which includes the list of all sources that have been used in the process of doing research for this study.

## **2. Informal Economy**

All unregistered and/or small-scale firms that generate goods or services for sale or barter and operate to deliver income to their owners and employees are considered informal. Small businesses are included in this definition because they are frequently exempt from employee registration and are unlikely to be taxed or subject to labour law enforcement. The concept of the informal economy is originally applied to self-employment in small unregistered enterprises. It has been broadened to include wage employment in non-protected positions.

De Soto (1986) defines the informal economy as

*the source of entrepreneurship that seeks income outside the formal economy due to the pressures of government regulation.*

The definition proposed by Buehn, Dell'Anno, and Schneider (2012), Schneider and Colin (2013), and INEI (2016) defines the informal economy as

*a set of productive activities liable to tax and social contributions that are deliberately hidden from tax authorities due to tax burden.*

The informal sector has received mixed reviews in development circles. Many observers saw the informal sector as marginal or peripheral, unrelated to the formal sector or modern capitalist development. Some of these observers assumed that if Ghana, Kenya, and other developing countries achieved adequate levels of economic growth or contemporary industrial development, the informal sector would disappear. Others claimed that industrial development in developing countries might follow a different pattern than in rich countries, including the increase in informal economic activity.

The economic crises in Latin America in the 1980s emphasized another element of the informal sector: employment in the informal sector, rather than or in addition to open unemployment, grows in many countries during economic downturns (Tokman 1984). During the Asian economic crises of the 1990s, millions of people who had lost formal employment in the erstwhile East Asian Tiger countries sought work in the informal economy (Lee 1998). Meanwhile, structural adjustment in Africa and economic change

in the former Soviet Union and Central and Eastern Europe were linked to an increase in informal employment.

During times of economic adjustment or change, employment in the informal economy often expands. When businesses are downsized or closed, people who are laid off and unable to find other formal jobs sometimes end up working in the informal sector. This is especially true for people who cannot afford to be unemployed, which is especially true in countries without unemployment insurance or compensation. When hard times are followed by rising inflation or reductions in public services, households frequently need to augment formal sector revenues with informal earnings.

During the 1990s, economic globalization contributed to the informalization of labour in numerous industries and countries (Standing 1999). While globalization has the potential to create new jobs and open new markets, many of these jobs are not "good" jobs, and many of the new markets are unavailable to small-scale or disadvantaged businesses. This is due to the fact that, in reaction to global competition, formal enterprises tend to hire all but a few core employees under informal arrangements or outsource the production of goods and services to other firms and nations (Rodrik 1997). Furthermore, informal enterprises and small producers frequently lack the market knowledge and skills necessary to compete with formal firms for export markets, and they also face competition from imported goods in domestic markets.

There is a growing realization that much of the informal economy is now integrally associated with the formal economy and contributes to the entire economy and that assisting the working poor in the informal economy is key to reducing poverty and inequality.

In conclusion, while interest in the informal sector has waxed and waned since the early 1970s, the notion has remained valuable to many politicians, activists, and researchers. This is due to the importance of the reality that it aims to capture: the enormous share of the global labour that contributes considerably to the global economy while remaining outside of the state's protection and regulation.

Informal employment accounts for half or more of total employment in poor nations and is becoming a larger proportion of total employment in developed countries. In 2018, the International Labor Organization (ILO) announced the first-ever estimates of

the world's informal labour force representing that almost 2 billion workforce which is about 61 percent of all workers earn their living in the informal economy.

### **Main facts about the Informal Economy:**

- Activities that have a market value but are not formally registered make up the informal economy.

The informal economy includes a wide range of occupations, including hawkers at traffic lights around the world, market stands in Latin America, and minibus drivers in Africa. In developed economies, examples can include gig and construction workers, domestic workers, registered businesses that carry out unauthorized activities, and more.

According to the International Labor Organization, over 60% of the adult labor force worldwide, or about 2 billion workers, work at least part-time in the unorganized sector. Although the informal economy is a worldwide phenomenon, there are significant differences between and within nations. In low- and middle-income countries, it accounts for an average of 35% of GDP, compared to 15% in advanced economies. The regions with the highest rates of informality are Latin America and sub-Saharan Africa, while the regions with the lowest rates are East Asia and Europe.

- The informal economy is tough to measure.

This is due to the fact that its operations cannot be directly observed and that its users, for the most part, do not want to be counted. But because of its importance and the fact that it employs some of the most vulnerable people in the world, it is crucial to make an effort to estimate the size of the informal economy. Two methods can be used to gauge informality. The direct method relies on surveys, voluntary responses, and other compliance techniques to determine the precise number of informal businesses and employees. The focus of indirect methods is on specific traits, or proxies, that can be seen and are connected to unofficial economic activity. Proxy measures include things like electricity use, satellite

data on nighttime illumination, and money in circulation. These techniques can be used to calculate the informal economy's contribution to the overall output.

- Women, in particular, were particularly hard-hit by the COVID-19 pandemic among informal workers.

Due to the fact that the majority of informal workers are employed in industries with high contact requirements (like domestic helpers, market vendors, and taxi drivers), they are more likely to experience job insecurity and jobs without paid time off or remote work options.

Compared to Pre-pandemic predictions, close to 95 million more people—many of them undocumented workers—are estimated to have lived below the extreme poverty line in 2020.

Since the beginning of the pandemic, millions of women who are informal workers have been forced to stop working, contributing to an increase in gender inequality. As an illustration, women account for 80% of all domestic workers worldwide, and 72% of them have lost their jobs as a result of the pandemic. Comparatively to businesses owned by men, 41 percent of women's businesses in sub-Saharan Africa failed.

- The process of economic development is fundamentally reliant on the informal economy.

Understanding the causes and effects of informality is essential for achieving inclusive and sustainable development, as informality has a direct impact on the rate of economic development, poverty, and inequality, including gender inequality. While some people and businesses choose to operate informally, the majority of informal workers—85 percent—are in precarious jobs because there aren't enough opportunities in the formal sector. This has significant economic ramifications.

First, nations with sizable informal economies frequently experience below-potential growth. Informal businesses typically remain small, have low productivity, and have restricted access to capital. Additionally, they do not contribute to the tax base, which denies governments the funds they need to provide essential services to their people.

Second, compared to their counterparts in the formal sector, informal workers are more likely to be poor and earn lower wages. They are generally less educated and have less access to credit and social protection.

Third, gender inequality and informality are related. Women make up 58% of the working population worldwide, and they are more likely to be employed in low-wage, precarious jobs than men. In the non-agricultural sector of sub-Saharan Africa, women make up 83 percent of all informal employment.

- Since the informal economy currently serves as millions of people's sole source of income and essential safety net, it is imperative to address it in a balanced manner.

The drivers of informality in each country, such as social exclusion and the incentives for people and businesses to operate informally, must be addressed by policymakers in order to reduce informality gradually. Attacks on the industry motivated by the idea that it is unlicensed and avoids paying taxes are not the solution.

Instead, policies that have been found to be successful include measures to ensure that boys and girls have equal access to education; expanding financial access, including by utilizing mobile money and digital reforms; and putting in place measures to enhance the business climate. Reforms to the labour market are among the specific measures, along with measures to make it easier for new businesses to register and comply with regulatory requirements.

### **Different Views on Informality**

Since the definition of "informal economy" in 1972, the ILO has taken the lead in investigating both the conceptual and underlying social and economic difficulties associated with this phenomenon. On the one hand, some businesses do not register or comply with regulations; they sell and pay for inputs, including labour, in cash; and they do not pay taxes. On the other hand, as we have seen in transition economies, registered enterprises conceal some of their sales revenue from the authorities in order to decrease their tax payments while still employing formal personnel and according to numerous laws. Firms can avoid paying taxes and making social contributions in various ways, either totally or partially. These ambiguities represent challenges in quantifying and identifying the extent of informality. Nonetheless, four major

paradigms for explaining the presence of the informal sector have been established: dualist, structuralist, legalist, and voluntarist.

- **Dualist View**

A dualist view of the economy divides it into two different sectors: formal and informal. Dualists believe that the informal and formal sectors are completely disconnected and that economic development will either alter or absorb the informal sector. The informal sector is regarded as an autonomous part distinguished by its provision of jobs, goods, and services to a country's urban poor. This judgment reflects a lack of connections between the informal and formal sectors, and informal firms nearly never become regular enterprises. According to the dualist paradigm, the informal sector exists as a subsistence economy that reflects the formal economy's inability to provide sufficient jobs for its labor force.

- **Structuralist View**

The coexistence and links between informal and formal sectors are considered by critics of the dualistic approach, as pushed by structuralist scholars. Rather than adhering to a two-sector economic separation, they see a continuity of economic activities. According to this point of view, the informal sector should be viewed as subordinated economic units—micro-enterprises and workers that assist to cut input and labor costs and so boost the competitiveness of large firms. [22] In comparison to identical operations created in the formal sector, the informal sector is more economically efficient and has comparative advantages. [23] As a result, the informal sector has a beneficial economic impact in developing nations since it provides sources of livelihood and economic opportunities that the formal sector does not.

- **Legalist view**

Government deregulation, according to legalists, would encourage economic freedom and entrepreneurship among working people, particularly in emerging countries. [24] Reduced regulatory hurdles, the elimination of needless bureaucracy, and the formalization of property rights for the informal workforce will assist them in converting their informally held assets into real assets. Undefined legal property is a source of income for the informal economy and a hindrance to entrepreneurial activity.

- **Voluntarist view**

According to the voluntarist approach, informal activity in developing nations is part of a voluntary small-firm sector similar to those in advanced countries that, due to inadequate enforcement of labor and other rules, can pick the appropriate level of participation in formal institutions. In the developing world, the formal sector's provision of benefits is frequently inefficient and of poor quality. Because workers tacitly or overtly pay for these deficiencies to the extent that perceived benefits fall short of tax expenditure, there is an incentive to engage in tax evasion and become a part of the informal sector. Informal businesses decide to operate informally after assessing the costs and benefits of informality vs formality. The causal roots of the informal economy can be traced back to efforts made in the formal economy to escape taxation and costly regulation.

## **Causes of Informal Economy**

In general, the major reasons for the formation of the informal sector are income disparity, poverty, unemployment, economic growth, and economic crises. Other issues are more closely related to the government over-regulation and a high tax load. Some authors place a special emphasis on social and labor regulation when discussing excessive regulation (social security contributions, vacations, etc.). Another frequently cited argument is the so-called social contract or social agreement made between a government and the population of a country, emphasizing the concept of tax morale. Other sources of informality include institutionalization, defined as the transparency of institutions and governments, as well as corruption and how rules and regulations are administered. Finally, education and behavioral factors are thought to be important in understanding why informal agents remain informal. The informal economy exists because formal arrangements, such as laws and regulations, are not adequately applied, observed, or applicable. As a result, a key component of the ILO's work on formalizing the informal economy is to gradually enhance the legal environment and compliance with the law and international labor standards.

Another main reason for informality is weakness in the institutional framework; because the informal sector is complex and diverse, it is impossible to create a universal definition of its core causes. Informality is widely viewed as a byproduct of excessive regulations and entrance barriers into the formal sector. This is the legalistic tradition of informality's point of view (De Soto, 1989; Djankov et al., 2002). To what extent this reasoning explains informality in Peru, an examination of the precise regulations that apply to different kinds of enterprises and workers, the types of incentives created, and the costs and benefits of formalization are required.

### **Consequences of Informal Economy:**

There are many repercussions of this phenomenon, much like there are many causes. The effects of the informal economy on economic, social, and tax policies are highlighted: the more informal the economy, the less effective are social and economic policies (ant-inflationary policies, fiscal expansion policies, fight against poverty, etc.). Additionally, a lower level of tax collection is made, which is impacted by both a lower tax base and lower tax compliance rates per person.

Additionally, there are effects on the labour market, specifically in terms of job creation, labour costs, and the productivity and skill of the workforce that works in the unorganized sector, all of which affect the general populace's wealth and labour regulation. Some authors focus on the impact of the informal sector on the market, particularly on the rivalry between formal and informal businesses, which are viewed as dishonest because they don't follow the law and artificially keep their costs lower. On the other hand, it is acknowledged that businesses that operate in the informal sector typically have a limited capacity for technological advancement and innovation because of, among other things, the lack of access to funding sources and skilled labour, which results in a decreased level of productivity and a constrained ability to add value. In conclusion, the informal economy ultimately has a negative impact on a nation's economic development.

## Measuring Informal Economy

Any economic activity which falls outside the regulated economy and tax systems is the informal economy examples of which are; street vending and unregistered taxi drivers. Informal economy is therefore hard to measure.

Informal economy usually includes people and companies which operate on a small scale. Since the informal economy, also known as the shadow economy, lacks official statistics, economists must make an educated guess as to its size. Surveys and indirect indicators, such as the demand for currency, are a few typical techniques.

In terms of a percentage of GDP, the size of the informal economy has gradually decreased globally.

Based on an updated version of earlier IMF research, the informal economy's size as a percentage of GDP has gradually decreased across all regions.

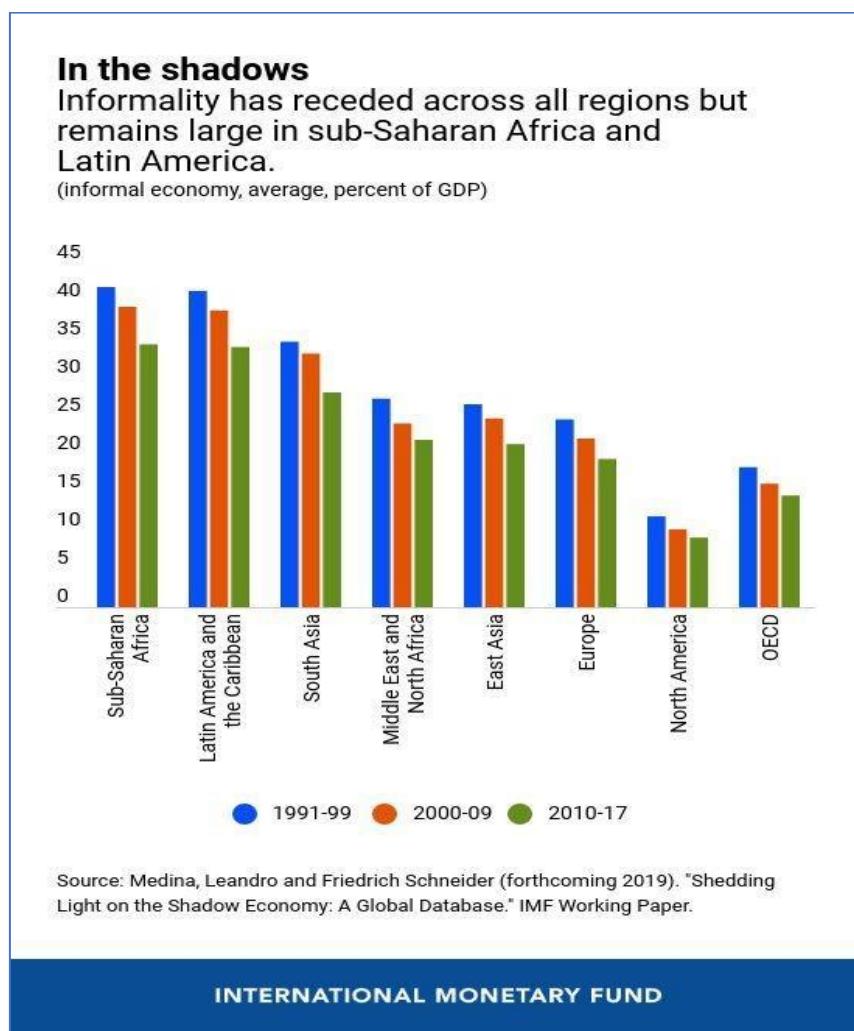


Figure 1 Informal economy, average, percent of GDP

Sub-Saharan Africa and Latin America and the Caribbean, both at 34% of GDP, had the highest share of informality between 2010 and 2017. In comparison, North America's GDP is 9 percent. The informal sector accounts for nearly 15% of GDP in the Organization for Economic Co-operation and Development.

In general, the informal economy is linked to low productivity, crushing poverty, high unemployment, and sluggish economic progress. Additionally, it is more common in low-income nations because workers are more likely to transition to the formal economy as a nation develops. Furthermore, it offers income and employment to those who would not otherwise be able to find work or supplements their income from jobs in the formal, regulated sector.

The difficult task facing policymakers is to foster an environment in which the formal sector can flourish while providing chances for those employed in the informal sector to maintain or raise their standard of living. Some of these actions include lowering business costs, combating corruption, and enhancing access to resources like money and services.

From a policy perspective, measuring the informal economy is crucial for obtaining precise estimates of overall economic growth as well as for providing targeted information on this sector, which may exhibit particular behaviors and call for different policies than the formal economy. For many nations, the informal economy has significant social repercussions in addition to economic growth. It enables those who might not be able to find formal employment to earn money. The size of the unofficial economy varies greatly between nations. It may also change over time within a nation, depending on factors like the economic cycle or an outside shock like the current COVID-19 health emergency crisis.

The following techniques have evolved over time for estimating the size of the informal economy:

Surveys of households or labour forces are the most common method for assessing local urban informal economies. Due to a lack of information on economic activity in these cities, the vast majority of these surveys have been carried out in developing-nation cities. The lack of survey research on informal economic activities in US cities has significantly hampered domestic understanding of the problem.

There are a number of indirect methods that have been developed over the past thirty years that are frequently intended to capture macrolevel informal economic activity if surveys are the direct methods for measuring activity. The contribution of informal economic activities has been estimated using a variety of statistical methods, including labour and employment statistics, electricity consumption, cash versus credit activities, income and expenditure ratios, local proxies, and other statistical analyses.

### **Direct Approaches:**

- **Surveys**

Numerous surveys have been conducted to gather information on the size, drivers, characteristics, and effects of the urban informal economy on urban areas. They can be used at both the national and local levels, depending on the scope, time, and budget. Surveys have been the main source of data on a growing number of issues connected with the urban informal economic activity in developing countries, where other institutionalized and systemized data is less reliable, providing insights into labour exploitation, sexual harassment, and poor working conditions; enhancing data comparability; micro-finance, micro-insurance, micro entrepreneurs; and understanding profiles of rural and urban informal sectors in tertiary education.

The fact that the success of surveys in gathering information about the informal economy depends significantly on the respondent's willingness to cooperate is one of the most frequently cited criticisms of these methods. Using a direct questionnaire to gauge the growth of undocumented work is challenging. Since most interviewees are reluctant to admit to engaging in fraudulent behaviour and responses are frequently unreliable, it is challenging to determine the extent of undeclared work in terms of money from these types of responses. The fact that surveys are expensive, time-consuming, and challenging is another drawback.

- **Tax Auditing**

A tax audit is the process of examining and verifying a taxpayer's financial records to ensure they are in compliance with income tax laws.

By measuring the difference between income reported for tax purposes and that measured by institutional checks, the Tax Auditing method estimates the size of the informal economy (like Federal fiscal auditing programme for instance). There are several issues with this strategy. First off, using tax compliance data is the same as using a sample of the population that may be skewed.

Such a sample is not a random one of the entire population because, in general, the selection of tax payers for tax audit is based on characteristics of submitted tax returns indicating a high likelihood of tax fraud. Estimates of the informal economy based on compliance are likely to be biased by this factor. Second, estimates based on tax audits only take into account the income from the informal economy that the authorities were able to find, which is probably a small portion of the hidden income (Schneider 2002).

### **Indirect Approaches:**

- **Analysis of the labour market**

Labor market analysis can provide significant hints about the size and make-up of the informal economy workforce if data are both accessible and available. Difference between the official and actual labour force can also be used to measure informal economy. If the total labour force participation is assumed to be constant, a decline in the official labour force participation can be interpreted as an increase in the importance of the informal economy. These estimates are poor measures of the size of the informal economy because changes in the participation rate could have a variety of other causes, such as changes in the business cycle, the difficulty of finding employment, and decisions regarding education and retirement.

- **Analysis of currency demand**

The currency demand approach is one of the most well-liked and dynamic ways to gauge the informal economy (Schneider and Enste 2000). The underlying presumption

of this approach is that cash is used in informal economic transactions (Cagan 1958). Estimates of the size of the informal economy are derived by examining the relationship between the demand for US currency and the impact of taxes. Initially examining the ratios of currency demand to tax burden, this approach eventually developed into econometric models that account for payment patterns, interest rates, and other pertinent factors (Tanzi, 1980). In the equation, a rise in the informal economy was associated with a rise in currency demand. Later, the currency demand method replaced tax pressure by comparing the value of the circulating currency to the US GDP. Eventually, the model underwent yet another evolution to take globalization-related increases in U.S. currency into account. The quantity of large denomination notes in use, the cash-to-deposit ratio, and the volume of financial transactions are additional monetary indicators.

The currency demand approach presents some difficulties in national and micro market estimations, despite being acknowledged as a reliable method for estimating the size of the informal economy. First, even though cash is still used for most transactions in the informal economy, it is not always the case. According to research, cash is used in about 80% of transactions (Isachsen and Strom, 1980). Second, the methodology presupposes that there was no informal economy in the base year for comparison of the ratios of cash demand to either tax pressure or U.S. GDP (Schneider, 2002). This assumption is not supported by the method's data. Third, tracking dollars outside of the United States has become an imprecise science due to the U.S. dollar's continued rise as a global currency (Feige 1996). The fact that the currency demand method is a macro approach presents the biggest difficulty in quantifying neighbourhood informal economies. Neighborhoods, or micro markets, are too small an area to estimate currency demand because of their mobile populations and fluid boundaries.

- **Electricity Consumption**

The electricity consumption method makes the assumption that electricity consumption is the best physical indicator of economic activity (Kaufmann and Kaliberda 1996). The

electricity consumption method examines the connection between electricity consumption and GDP, much like the currency demand method does. The difference between the growth of GDP and electricity use is attributed to the informal economy after empirical evidence demonstrates that electricity consumption and GDP share the same elasticity. Although this method, like the currency demand method, produces estimates of the size of the informal economy, there are some difficulties. Schneider claims that not all informal activity needs electricity in his critique of the approach. One common practise that uses little to no electricity is the distribution of goods on the street. Second, depending on the specific market, the effectiveness of the electricity distribution, and the machines being used, the elasticity of electricity consumption can vary (Schneider 2002). Thirdly, similar to the currency demand method, the main issue with this GDP-based approach to quantifying the informal economy at the national level is that it is a macro-level approach. However, at the micro market level, where it can be correlated with local transactional data, a method for measuring electricity consumption, or an adaptation to measuring water or telephone usage, may be easily employed. Lower geographies may have access to utility consumption data, which would enable analysis at the neighbourhood level. The rules of state utility commissions and whether the utility is publicly or privately owned frequently determine the accessibility of this data. In some cases, publicly owned utilities provide data at the address level for public interest research.

- **The use of neighborhood proxies**

In order to estimate the income produced by informal activity that might have been overlooked in census and census upgrade profiling, Social Compact's model uses proxies (measurable at the neighbourhood level) of informal activity. Over the course of its eight-year use, the model's proxies have increased, but the methodology has largely not changed. Currently, Social Compact measures eight proxies to estimate local informal economy activity and associated income using a combination of publicly and privately available data.

- % of households with a total income of less than \$30,000

- Ratio of household expenditures and income
- % of households with no banking relationships or credit histories
- % of utility payments made in cash
- The prevalence of check-cashier operations per acre in the profiled neighborhood
- The prevalence of check-cashier operations per household in the profiled neighborhood
- Modeled versus actual housing costs
- % of the neighborhood's population that is foreign born

- **The difference between income statistics and national expenditure**

The difference between national income and national expenditure estimates can be used to estimate the size of the informal economy if people who work in it are able to conceal their incomes with the intention of evading taxes but not their expenditures. This method would produce a reliable estimate of the size of the informal economy if all the expenditure side components were accurately measured and constructed so that they were statistically independent from income factors. Unfortunately, other types of omissions and errors are also reflected in this gap, and several expenditure estimates are based on income calculations. As a result, this method's reliability is up for debate.

- **Transaction Approach**

Using Fischer's quantity equation,  $\text{Money} * \text{Velocity} = \text{Prices} * \text{Transactions}$ , and making the assumption that there is a constant correlation between the money flows associated with transactions and the total (official and unofficial) value added, i.e.  $\text{Prices} * \text{Transactions} = k (\text{official GDP} + \text{informal economy})$ , it is straightforward to obtain the following equation:  $\text{Money} * \text{Velocity} = k (\text{official GDP} + \text{informal economy})$ . The stock of money and official GDP estimates are known whereas money velocity can be estimated. Therefore, the informal economy can be calculated for the remainder of the sample if the size of the informal economy as a ratio of the official economy is assumed to be known for a benchmark year. The assumption that  $k$  remains

constant over time seems quite arbitrary, and other factors, such as the development of checks and credit cards, could also affect the desired amount of cash holdings and, consequently, velocity. Despite being theoretically appealing, this method has a number of flaws.

### **Issues and challenges in measuring informal economy**

Although the informal economy has long attracted significant interest, it has become even more so in light of the current COVID-19 health emergency crisis. However, there is currently no established statistical framework for measuring and presenting the informal economy. A situation where countries are developing their own definitions with varying interpretations of the scope of informality has resulted from the absence of common concepts and measuring frameworks. International comparability is hampered by this. Non-official estimates based on indirect methods, frequently employing monetary methods, are typically used to close the gap. These financial techniques frequently produce high estimates that grab the public's attention, but they are also quite approximative and don't always ensure the accuracy and dependability of the outcomes.

Although countries have estimated the unobserved and informal economies as part of their exhaustiveness adjustments, the estimates are not distinct from one another.

Direct measurements are challenging to come by; while some informal activity may already be covered in macroeconomic data using conventional techniques, the remaining portion is evaluated using assumptions, suggestive data, or indirect methods. The informal economy may frequently be combined with other parts of the unobserved economy during the adjustment. The risk of double counting may also exist, though it occurs less frequently, for example, when money laundering occurs and legal entities carry out illegal or other unregulated transactions before moving the receipts to the legal market and paying taxes on them.

Measuring the informal economy will continue to be difficult, even with a standard framework. Informal activities are not well-represented in regular data sources for the measurement of productive activities, such as business surveys, customs data, administrative data, and tax data. It would be necessary to develop new surveys with a

focus on informal activities or modify current surveys like LFS. Creating and balancing supply and use tables could yield a substantial amount of information and data regarding the size of the informal economy. Evidently, many nations lack the funding necessary to regularly carry out this work.

The measurement of the informal economy and its associated activities has become more challenging as a result of digitalization. It has produced new services as well as increased opportunities for new forms of employment. On the other hand, measuring informality may benefit from the use of big data and other fresh data sources.

## **Informal Sector and SDGs**

The informal sector has far-reaching consequences for the economic and social development of developing and developing countries. Sustainable development is seen as the ideal development paradigm, with three goals in mind: environmental conservation, economic efficiency, and social equality.

The informal sector is highlighted as a potential contributor to more than four entry points of an urgent transformation in the socioeconomic and environmental systems that may divide nations but can add up to global outcomes that prioritize human well-being, social health, and minimal environmental impact. However, because of its ubiquitous characteristics of non-regulation by formal institutions, the role of the informal sector in sustainable development has been disputed in several studies.

The main issue with the informal sector in terms of sustainability is that production and commercial operations in this sector do not provide long-term economic efficiency and welfare, despite the fact that it has the potential to provide more effective fulfillment to social demands. By distorting the factor, resource, and product markets in a variety of ways, the informal sector generates a decentralized style of economic organization that makes formal coordination and planning difficult. It has a detrimental impact on formal investment and stifles the economy by preventing the government from earning money. As a result, it prevents the public sector from complementing private investment through infrastructure development and business environment enhancement. Economies with a high level of informality suffer challenges in obtaining financing,

weak investor protection, and inefficient tax and licensing procedures, raising the danger of the formal sector collapsing.

Furthermore, precarious work circumstances are noticeable in informal firms where workers are denied their rights and face a heightened risk of abuse and employment insecurity. Contrary to popular belief, the informal sector is seen as a lifeline for the poor and logical response to overburdened rules, ultimately providing the economy with a dynamic and entrepreneurial spirit through competition, innovation, efficiency, and investment.

In the context of the environment, informal economic activities are frequently associated with land, water, air, and sound pollution on the one hand, and are praised as environmental cleaners due to their ability to reuse waste materials generated by the formal sector on the other.

The informal sector operates outside of the formal economy, where small-scale production and business activities are carried out by subsistence entrepreneurs and workers without the benefit of a contractual agreement or a division of labour and capital. These unincorporated private firms are poorly managed, under-capitalized, less productive, and impermanent, with little or minimal coverage provided by formal agreements.

They manufacture goods and services at a lower level of organization and technology with the initial goal of creating employment and income. These actions are largely unrecorded and unrecognized, and they are frequently regarded as a source of incorrect formal-sector functioning that threatens sustainability.

Because workers become business owners with no preparation to operate the business, their profit is minimal and largely limited to informal means of complying with government regulations, taxes, and property rights. Due to unfair rivalry with formal enterprises, these limits give rise to a contrasting perspective of informal sector operations and advertise its concealed threat. Informal sector activities are frequently regarded as a result of poverty and regarded as the last alternative for poor, unskilled, low-paid employees.

## **Informal sector and the economy**

Despite the ongoing view of the existence of a significant informal sector as a barrier to investment, growth, and development, it has expanded in emerging nations due to the rapid growth of already widespread unemployment. In emerging countries, the informal sector is shown to be dependent on economic growth, working-age population, government policies, and trade-related globalization. A well-functioning and regulated informal economy has been identified as a vital prerequisite for achieving long-term economic progress. However, because the relationship between informality, growth, and inclusivity was not well understood, other studies identified significant informality as a barrier to long-run economic development and poverty alleviation.

*Elgin and Birinci (2016)* predicted an inverted U relationship between the informal economy and economic growth in the long run, with low-income nations showing a negative correlation while high-income countries showed the opposite.

Recent research has centred on the formalization of business. Barron (2020) discovered greater evidence of small-scale enterprise formalization after analyzing the effects of two big business training programs on micro enterprise formalization in Peru. This study's improvement has been aided by the ability to evaluate the company plan, the declaration of tax procedures, and access to basic finance.

## **Informal sector and the Environment**

The scale of the informal sector is significant for assessing the efficacy of environmental policies. When the informal sector was linked to formal economies, it was shown to be the long-term driver of ecological footprint levels. In general, a growing informal sector adds significantly to environmental damage since enterprises engaged in the sector can avoid environmental regulatory rules. *Elgin and Oztunali (2014)* used an inverted U model to show that lower levels of pollution were connected with small and large size informal economies, while greater levels of pollution were associated with medium size informal economies. In the case of air pollution (both local

and global), the shadow or informal economy was found to have a positive marginal influence.

The detrimental impact of the shadow economy on pollution could be mitigated by reducing the level of corruption that has fueled the expansion of the shadow economy in developing countries. A lower level of corruption is also proposed for lowering the informal economy's marginal influence on environmental damage. Because the informal sector in developing nations relies on labor-intensive production techniques and uses less energy, emissions are lower.

As a result, adequate fiscal policy was proposed in these research in order to transition to cleaner economies. Certain smaller taxes on environmental externalities could become more efficient in the presence of the informal sector if a model for an ideal tax that captured substitution between formal and informal sections of the economy was introduced.

*Chaudhuri and Mukhopadhyay* proposed an indirect approach of pollution mitigation as well (2006). According to this study, formal sector enterprises that used informal sector output as an intermediate input should be taxed more heavily because informal sector units could not afford to pay pollution taxes, install pollution abatement equipment, or be targeted for their polluting operations.

### **Informal sector and the Social Issues**

Although the informal sector accounts for about half of economic activity and contributes to employment in developing countries, there is no agreement on the utility of such employment in terms of poverty eradication, which is a key issue for sustainable development. Because they are not in a socioeconomic position to wait indefinitely for a high-paying job in the formal sector, informal sector workers are obliged to take low-wage positions with insufficient job security in cities. Workers in informal enterprises with no social security or health benefit plans are frequently subjected to challenging and hazardous working circumstances.

*Gangopadhyay et al. (2014)* developed an index of destitution for the working poor in developing nations' informal sector, which described several economic and social

variables responsible for deteriorating destitution among the working poor in the informal sector. Profit calculations overlook destitution and poverty.

The informal sector's socioeconomic aspects had a favourable impact on the economy. Despite their harsh and fragile circumstances, informal companies can undertake social duty implicitly.

The informal sector has the potential to provide a balance between the "Three Es": economy, environment, and equity, as well as an intra and inter generational future. All of these disparate findings point to a study deficit in understanding the relationship between informal business and production performance, as well as the three dimensions of sustainability. Finally, the impact of informal sector activities on the overall effect of these three sustainability characteristics remains critical.

### **3. Informal economy in Peru**

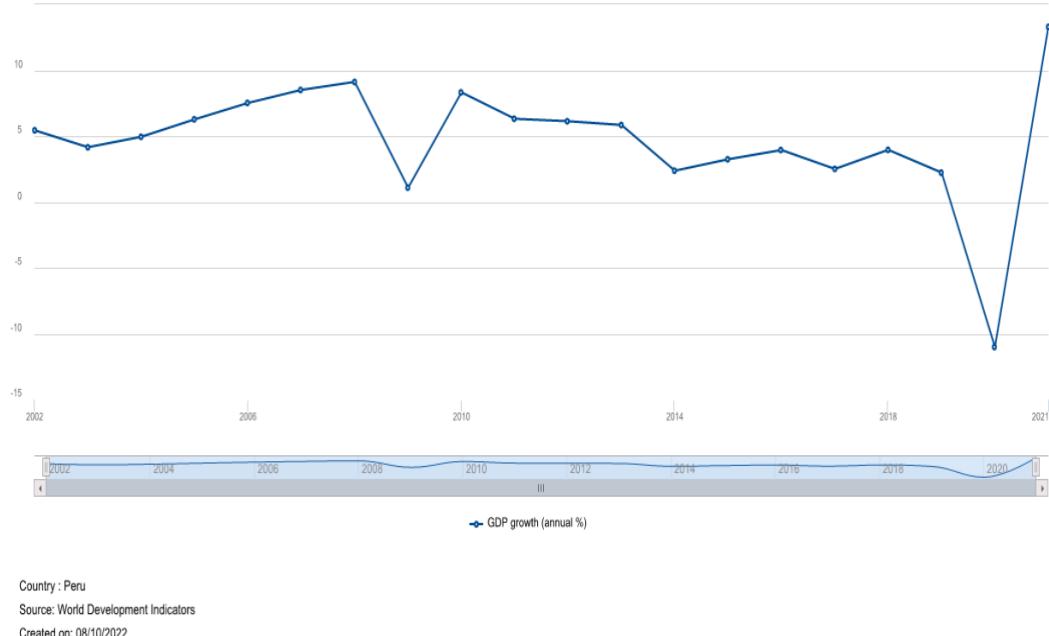
The informal sector and informal employment are two separate ideas that fall under the umbrella of the informal economy. The term "informal sector" refers to all individuals working for at least one unofficial enterprise and is enterprise-based. It is calculated as the portion of GDP attributed to production in these businesses. Informal employment is based on jobs, treating jobs and employed people as separate entities. The percentage of the total labour force that is employed is used to measure it.

Peru has sound macroeconomic fundamentals, including a solid central bank, a large amount of foreign reserves, and a relatively low public debt to GDP ratio. The economy of Peru experienced a strong recovery in 2021, but structural rigidities in the labour market and inflation limited the country's ability to reduce poverty. In 2022, GDP growth is anticipated to resume its Pre-pandemic trend of roughly 3% annually, as the increase from favourable export prices offsets the impact of political unpredictability. But poverty is anticipated to stay significantly higher than it did in 2019.

Real GDP increased by 13.3 percent in 2021, recovering to its Pre-pandemic level following a severe recession in 2020. Domestic demand drove the recovery, which was aided by rising public and private spending. Although employment levels are almost

back to where they were before the crisis, this was largely due to low-quality jobs in the unorganized sector. In fact, formal employment is still more than 20% below Pre-pandemic levels in urban areas. Household income has decreased due to lower-quality employment, and by the end of the year, the average wage was still 13 percent below what it had been in 2019. Poverty decreased by an estimated 4.6 percentage points in 2021, reaching 28.3 percent, still significantly higher than it was in 2019. The GDP rebound was largely to blame for this decline.

One of the fastest fiscal consolidations in the area occurred in 2021, when the public deficit decreased from 8.9 percent in 2020 to 2.6 percent. This decrease was primarily caused by a real increase in public revenues of 40%, which came about as a result of increased tax collection from mining companies, the impact of some administrative changes, and the prepayment of some tax fines. Just slightly above its levels in 2020, public debt rose to 36% of GDP.



*Figure 2 GDP growth of Peru*

The economy is anticipated to grow by about 3.4% in 2022, primarily due to increased export volumes, while domestic demand will progressively slow down. As significant copper mines start operating, exports will be supported. Due to the continuation of some

significant investment projects, capital expenditures in mining will continue to support private investment, offsetting the impact of low business confidence. In addition, a rise in private consumption is anticipated to be supported by the formal labour market's recovery and the gradual normalization of activities. After 2022, the current account deficit is anticipated to decrease, primarily due to the combined effect of rising exports and slowing imports in a setting of moderated domestic demand.

Accelerating GDP growth, fostering shared prosperity, and protecting citizens from both general and specific shocks are the economic challenges facing Peru. To achieve this, the government must improve the delivery of public services and regulatory quality, develop protection strategies, build out a better infrastructure for connectivity, and create policies to lessen market rigidities in both factor and good markets.

### **Why is it important to focus on the informal economy in Peru?**

Peruvian economic growth has remained constant at 5% over the past 20 years, in contrast to Latin America (3.8%) and the OECD (2.7%). It was one of the few economies to experience GDP growth after the financial crisis of 2008. Because of this, Peru's tax revenues (17 percent in 2015) have increased over the past 20 years, though not as much as the OECD (35 percent) or other Latin American nations (22%). (OECD, 2016). Although it has one of the most stable economies in Latin America, there is a complex phenomenon called the informal economy that has a detrimental effect on both the economy and society. If Peru does not reduce its informal economy, the informal sector could potentially be a major drag on the country's economic future. The effect that the unorganized sector can have on important economic factors like GDP, unemployment, and average income was examined in a study by CEPLAN<sup>1</sup>. The study examined a number of scenarios, including the most optimistic one in which Peru manages to reduce the size of its informal economy to 1% of GDP and the most pessimistic one in which current trends are maintained (CEPLAN).

For Peru's economy to continue growing in 2050, a persistent and sizable informal economy is undesirable. If not addressed, it will impede economic growth, decrease tax

revenues, increasing deficits and cutting funding for social programme while leaving millions of people without jobs and millions more with jobs but low wages.

### **Peru's informal economy size**

The portion of any economy that is neither taxed nor overseen by any form of government is known as the informal economy (also known as the informal sector or the shadow economy).

According to estimates, Peru's informal economy accounts for 42.2% of the country's GDP, or roughly \$270 billion in GDP PPP terms.

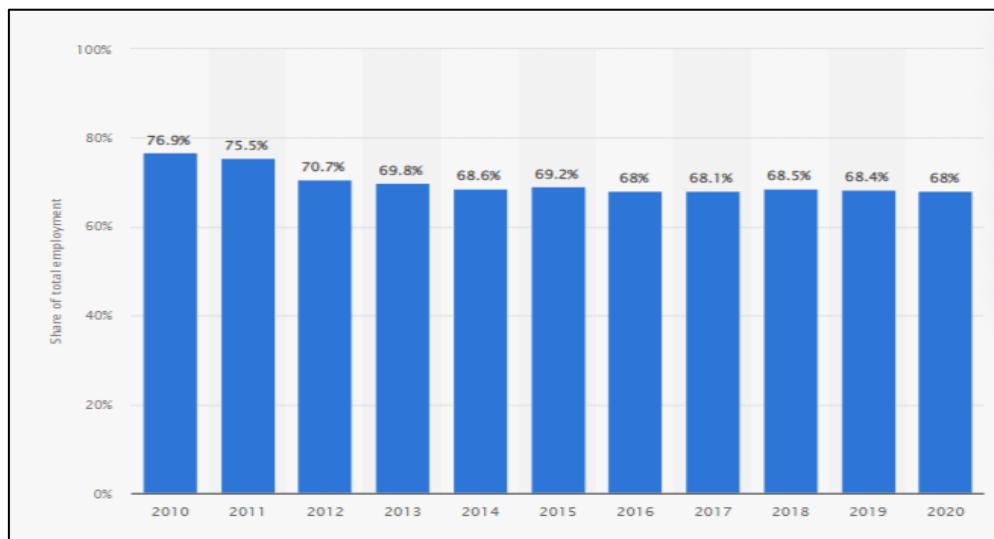
### **Share of informal employment in Peru**

No matter their status in employment or whether it was their primary or secondary job, employment in the informal sector refers to all individuals who, during a given reference period, were employed in at least one informal sector firm. An informal sector enterprise meets at least one of the following requirements: (i) the enterprise is not registered; (ii) the employees of the enterprise are not registered; or (iii) the number of people engaged on a continuous basis is below a threshold set by the country. An informal sector enterprise is (1) an unincorporated enterprise; (2) a market enterprise (i.e., it sells at least some of the goods or services it produces); and (3) it meets at least one of the following settings.

In 2020, informal employment accounted for 68 percent of the total employed population in Peru. This means that more than two-thirds of Peruvian workers were classified as unemployed. Despite a decline in percentage from the previous year, Peru remains one of the Latin American countries with the greatest proportion of informal employment.

Informality is widespread and persistent in Peru, having a significant impact on economic activity and employment. More than two-thirds of workers and over 90% of firms are informal. Although informality has declined, it has remained high over the most recent period of economic expansion and progress, and it is among the highest in Latin America and the Caribbean. Informality is one of the key hurdles to inclusive

development in Peru due to its negative impact on jobs, enterprises, and the broader economy.



*Figure 3 Share of informal employment as % of total employment*

Source: Statista

In Peru, informal employment is still prevalent and has survived over time. In 2014, it accounted for 72.8 percent of total employment (INEI, 2015). When applying the ILO definition of non-agricultural employment,<sup>1</sup> it is one of the highest in Latin America and the Caribbean at 68.8 percent, significantly above several benchmark countries (Figure 4.1, Panel A) (OECD, 2015a). In Peru, informal employment has been continually high, even throughout the recent period of substantial economic boom, when it fell from 79.9 percent in 2007 to 72.8 percent today (Figure 4.1, Panel B) (INEI, 2015). The majority of this drop occurred in metropolitan regions, but informal work is especially prevalent in rural areas. Without further action, this trend might continue, and informal employment could reach 50% by 2030, according to estimates.

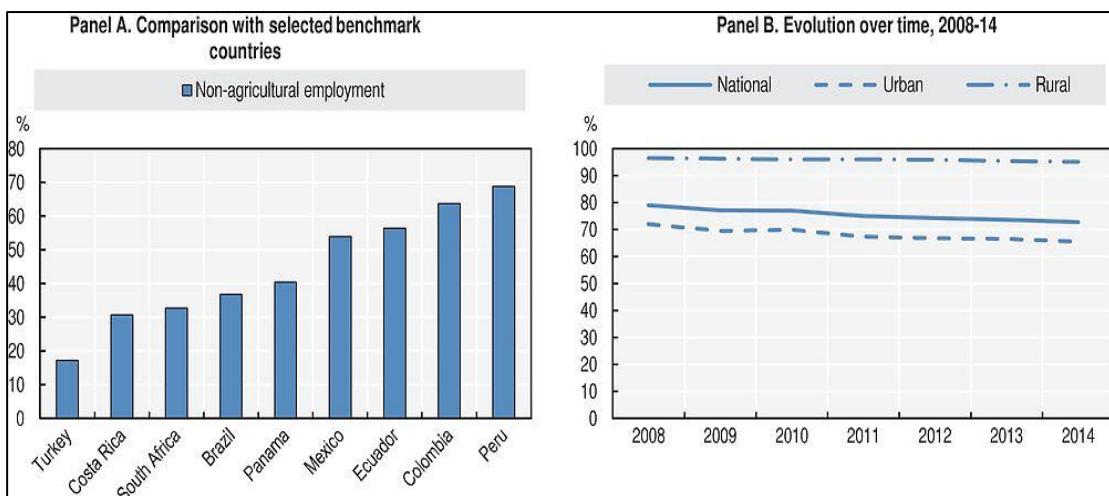


Figure 4 Panel A : % of non-agriculture employment

Panel B: Evolution overtime 2008 -14

Source: *Multi-dimensional Review of Peru: Volume I. Initial Assessment, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264243279-en>*

Although small, the fall in informal employment can be related to economic growth. Strong economic growth in Peru, particularly since 2002, resulted in a 44 percent rise in output per worker from 2004 to 2012, complemented by a little decrease in informal employment. However, economic progress has not reduced informality significantly, most likely because growth has been focused in industries with high productivity but minimal job creation. The majority of new jobs were created in low-productivity sectors under informal settings. In fact, despite net formal job creation and a decreasing rate of informality in new occupations, which have been primarily formal, the trend represented a modest fraction of total employment, and the elasticity informality-economic growth, which shows that the influence of economic growth on the elimination of informality, has remained low in Peru.

Institutional reforms in Peru have also contributed to the decline in informal employment. These include a new need, beginning in 2007, to provide to SUNAT an electronic payroll containing information on workers, pensioners, and service providers, among others - formerly submitted to the Ministry of Labour. Given the tax authority's heightened detection capacity, the new duty significantly increased the labor authority's

capacity to monitor compliance with labor standards. Other possible factors for the decline in informal employment include the implementation and expansion of special health insurance regimes, as well as the 2003 Small and Medium-sized Enterprises (SMEs) Law.

Because informality in Peru is generated by a variety of factors, including structural factors, the response must be multifaceted. Even after a long period of robust growth, Peru has only witnessed a minor drop in economic informality. This persistence implies that the drivers are multifaceted, involving both contextual and structural aspects. Informal employment and economic activity in Peru are highly heterogeneous and manifest in a variety of ways, necessitating a variety of policy approaches, including both short-term actions to address specific barriers to formalization and long-term strategies to create opportunities for more formal jobs and economic activity.

Reducing the informal economy is critical not just for tax collection (since the tax base can be expanded and tax evasion minimized), but also for Peru's economic growth. However, when it comes to taxation, the tax structure of Peru and Latin America is dominated by indirect taxes, resulting in limited re-distributive capacity and increasing inequality. On the contrary, in OECD countries, the system is progressive, with direct taxes dominating. Concentrating on direct taxation promotes welfare and equality, but only if the informal economy is absorbed and informal employment is reduced.

### **Causes of Informal Economy in Peru**

In Peru, the informal sector is powered by a mix of factors, some for survivalists and others for entrepreneurs.

### **Weaknesses in the institutional framework**

Because the informal sector is complex and diverse, it is impossible to create a universal definition of its core causes. Informality is widely viewed as a byproduct of excessive regulations and entrance barriers into the formal sector. This is the legalistic tradition of informality's point of view (De Soto, 1989; Djankov et al., 2002). To what extent this reasoning explains informality in Peru, an examination of the precise regulations that apply to different kinds of enterprises and workers, the types of incentives created, and the costs and benefits of formalization are required.

In Peru, the informal sector is powered by a mix of factors, some for survivalists and others for entrepreneurs.

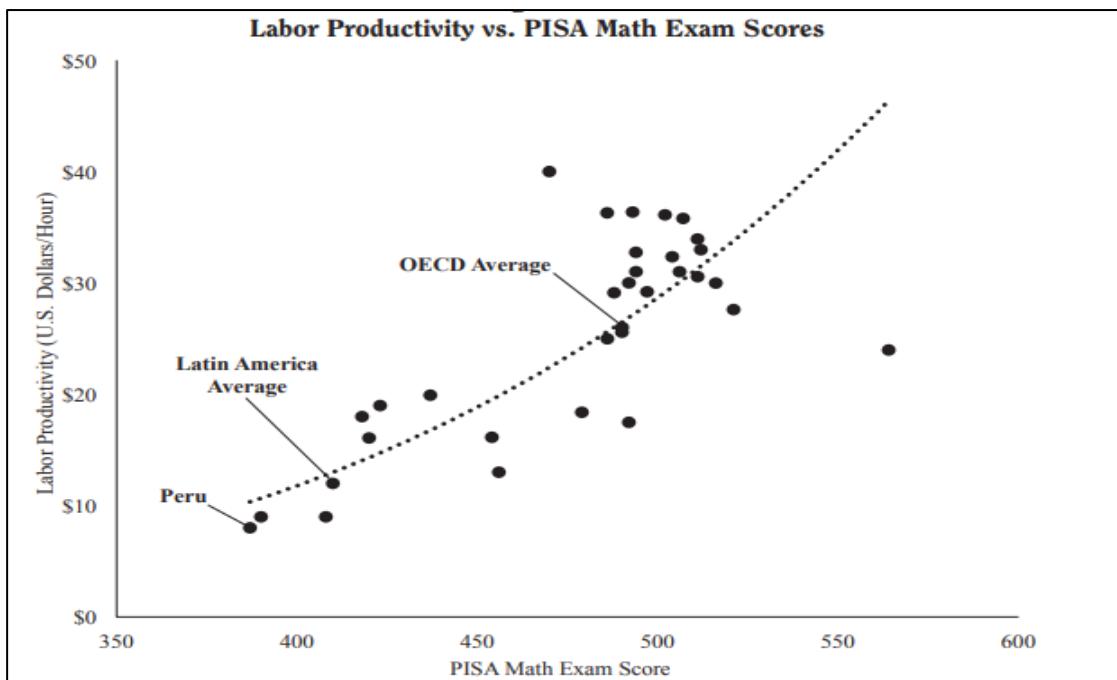
- **Survivalist Participation**

The inability to accumulate human capital is the foundation of the difficulty for the survivalist segment. In countries where social safety nets, such as unemployment insurance, do not exist, or if earnings and pensions are insufficient to pay the cost of living, informal sector employment is a vital survival strategy.

Survivalists have limited skills and competencies, create just enough cash to cover their expenses, and participate in subsistence activities to support themselves and their family. Because regulatory compliance implies certain monetary and/or non-monetary expenditures, formality is often out of reach for survivalist enterprises.

The average number of years of schooling is inversely proportional to the size of the informal economy. Informal activities account for 19 percent of Peruvian GDP,

While formal schooling for adults aged 15 and up lasts an average of 8.9 years. Peru also consistently performs towards the bottom of international standardized assessments such as the Programme for International Student Assessment (PISA).



*Figure 5 labor productivity vs. PISA math exam scores*

Source: Thorne

Low test scores and low worker productivity are strongly related (Thorne). Peru is ranked last, with the lowest PISA math test scores and labour productivity. This can be seen in the figure. Having more schooling boosts your chances of getting a job in the formal sector, but the effect is minor. The evidence reveals that labour supply is not the primary cause of the low proportion of formal positions; rather, demand side and regulatory constraints prevent more dynamic job growth in the formal sector.

- **Entrepreneurial Participation**

Drivers of informality for entrepreneurial participants include forces that operate as obstacles to participants joining the formal sector (to "push" them out of the formal sector) and forces that incentivize participants to formalize (to "pull" them into the formal sector).

Peru ranks 133rd out of 140 nations in terms of company hiring and firing flexibility. After four years, Peruvian employees' legal minimum wage has been raised to PEN 1,025 (about US\$ 277); last time, the wage was increased in 2018. It shows that

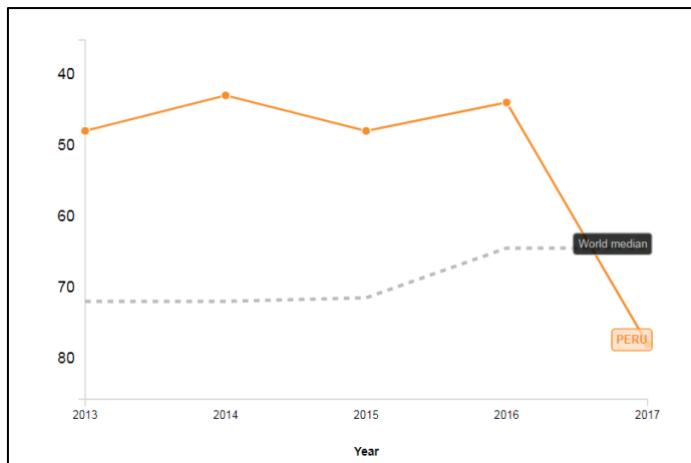
government of Peru didn't focused much changing the country's rigid labor regulation though they want to boost formalization in labor markets.

Peru's rigid dismissal **regulations** not only limit firms' ability to adjust employment levels to changes in market demand, but they also discourage hiring in the first place. The fact that more and more enterprises in the formal private sector are offering fixed-term contracts rather than open-ended contracts demonstrates that labour limitations are actually obligatory. Peru's tax-wedge is also high by regional norms, providing another deterrent for enterprises to establish formal jobs.

In 2019, Peru ranked 85th of 189 countries for its cost of doing business (World Bank). similarly Peru ranked 76<sup>th</sup> of 190 countries for its ease of doing a business. It takes more than three times as long for business owners in Peru to register their companies as it does in developed countries.A group of economists conducted an experiment to demonstrate the challenges of starting a business in Peru. After 289 days, the team finally registered the company. This is common for low-income Peruvians wanting to start small businesses.

In addition to laws, Peruvian **corporate taxation** is a significant push factor.The entire share of a firm's taxed profits and mandated payments is positively correlated with the size of the informal sector. Simply put, higher tax rates result in larger informal economies.Firms that are overburdened by taxes and mandated payments may avoid them by remaining informal, increasing net earnings. Participants face a cost-benefit analysis, which is made easier to resolve as the tax burden rises.

In the World Bank study, Peru ranked 78th out of 127 countries 2017, in ease of paying taxes.

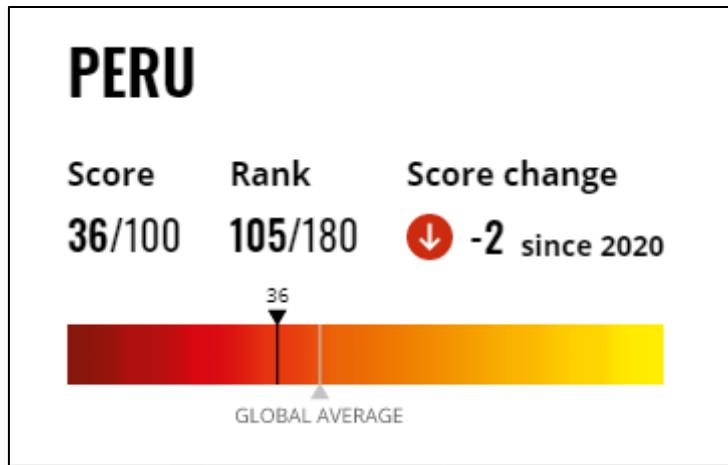


*Figure 6 Ease of paying taxes, Rank*

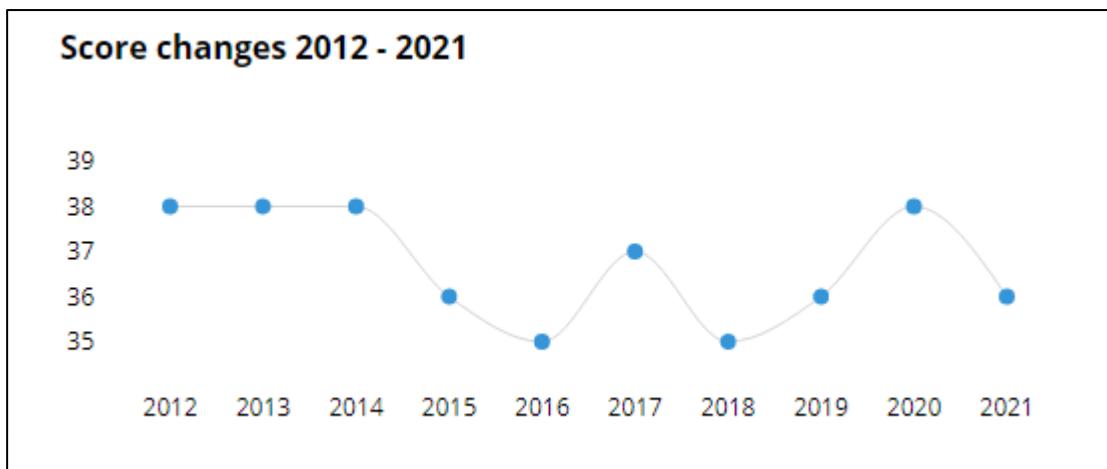
Source: [World Bank](#)

The last barrier to formalization is government **corruption**. A high level of corruption indicates a larger tolerance for undisclosed economic activities among officials. Despite the difficulty of assessing corruption, many studies use public perceptions of corruption as a barometer.

The Transparency International “Corruption Perception Index” assigns Peru a score of 35/100 in corruptness, with 100 indicating least corrupt. Peru placed 105th of 180 countries in perception of corruptness.



*Figure 7 Peru global average*



*Figure 8 Peru score changes*

Source: [World Bank](#)

Corruption is essentially an indirect tax that businesses pay in order to escape regulatory burdens. In a high-corruption environment, an entrepreneur in a lawful field of employment may feel the requirement to keep additional revenue off the books in order to pay officials who demand bribes. As a result, organizations confronted with high levels of corruption tend to consider the costs of formality outweighing the benefits.

Participants and businesses must assess the potential benefits of complying with state regulations. Government spending on R&D, government transfers to households, and government performance are all pull factors that are inversely connected to the extent of informal economies. Firms are strengthened and become more competitive as a result of R&D investments. Social programme and safety nets, such as state pension funds and welfare, are examples of government transfers. The linkage of these advantages to the formal economy creates substantial incentives to work in the official sector. According to the evidence, the efficiency of government in disseminating these incentives is essential to whether the incentives draw people into the formal sector.

## Low labor productivity: a barrier to formal economy

Labor productivity is an important economic indicator that is strongly related to an economy's economic growth, competitiveness, and living standards. Labour productivity is defined as the total volume of production (measured in terms of GDP) produced per unit of labour (measured in terms of the number of employed people or hours worked) over a certain time period. The indicator enables data users to assess GDP-to-labor input levels and growth rates over time, providing general information about the efficiency and quality of human capital in the production process for a given economic and social context, as well as other complementary inputs and innovations used in production.

Low productivity suggests that resources are not utilizing their abilities and competencies, which raises the company's resourcing costs. Lower productivity results in poor staff performance, which in turn lowers the quality of products delivered. When customers are dissatisfied with a product, profitability suffers. Gaining a competitive advantage in business requires innovation. If workers are not inspired to come up with creative ideas because they are not working at their best due to low productivity.

### Labor Productivity in Peru from 2010 to 2021



Figure 9 labor productivity in Peru 2010-21

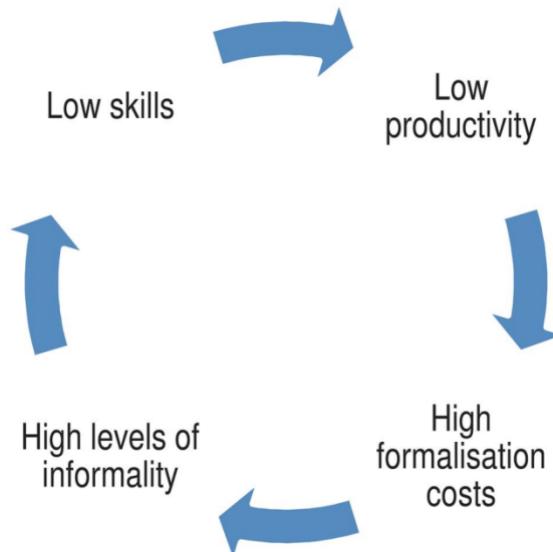
Source: [CEIC DATA](#)

Prior to the 2009 financial crisis, Peru's economic growth performance was exceptional when compared to other Latin American countries. Despite this strong increase, worker productivity growth was lower in the post-liberal reform period (1991-2005) than in East Asian countries and the United States of America. By 2007, Peru's labour productivity (or GDP per worker) was lower than that of other middle-income (big, medium, and small) Latin American countries such as Brazil, Argentina, Mexico, Colombia, Chile, and Costa Rica. Despite a range of economic crises (internal and international) and development strategies (inward and outward) between 1970 and 2011, production and trade patterns have not changed during the last four decades.

Thus, Peruvian GDP is mainly related to primary activities (such as agriculture, shing, and mining) and light manufacturing industries, with a minor contribution from processing and services.

Informality is largely associated with Peru's low labor-force productivity. Despite growth since 2002, Peruvian labour productivity has remained poor in recent decades, with a considerable gap with the United States. The most direct link between low productivity and informality is that low-productive workers do not generate enough value-added to justify the costs of formal hiring. Only under informal working conditions, their production is profitable. This significant relation between low productivity and high informality is supported by evidence, with larger degrees of informality concentrated in developing countries.

The productivity levels of a large share of informal workers result in production per worker that is insufficient to cover the minimum regulatory expenses of formal hiring (i.e. the minimum wage). If labour income is considered as a proxy for labour productivity, then the productivity of a considerable proportion of workers in Peru is lower than the minimum salary required if they were recruited formally. Low productivity is thus a functional barrier to formalization for this group of workers, as employers will not readily endure the costs of formalizing people who do not generate enough to cover their expenditures.



*Figure 10 self-reinforcing phenomenon*

In Peru, high informality and low skill levels encourage each other. Informality is both a cause and a result of low skill levels. The relationship between skill use in the workplace and productivity is very strong. Similarly, informality limits the pool of skills' expansion since, in an informal setting, certain abilities tend to deteriorate or remain limited to a low value-added range, and access to training and inter mediation services in the informal sector is limited.

Informality also limits skill development. First, in Peru, labour market segmentation is considerable, and the shift from informal to formal jobs is uncommon. This can be detrimental to skill development since persistence in unskilled labour or low-value-added work in the informal sector can lead to degradation or stultification in abilities that are not required. Second, workers in the informal sector are more difficult to identify and reach through training and active labour market policies, and training in informal workplaces is virtually non-existent.

### **Labor costs of formalization represent a barrier to formality for low-income groups in Peru**

Small-scale firms and workers with low skill levels may find that the cost to become formal is too high for them to register. Differences in informality rates among regions

are directly related to differences in productivity levels as well as the proportion of total labour costs devoted to social security. There are significant disparities in total labour costs and wage wedges (the fraction of total labour costs that goes toward paying taxes and social security contributions) between departments, urban and rural settings, and geographic areas.

In general, labour costs are higher in urban areas. Formalization costs are distributed proportionally across all departments, however total labour costs vary somewhat. Informality is lower in geographic areas when the total labour cost is higher than the minimum labour cost. In this regard, the presence of large, competitive, productive industries and rich commodity resources within a department is a strong indicator of higher levels of revenue, higher labour costs, and lower levels of informality. In these areas, social security costs are a lesser proportion of overall labour costs.

### Total labour costs in Peru by geographic location

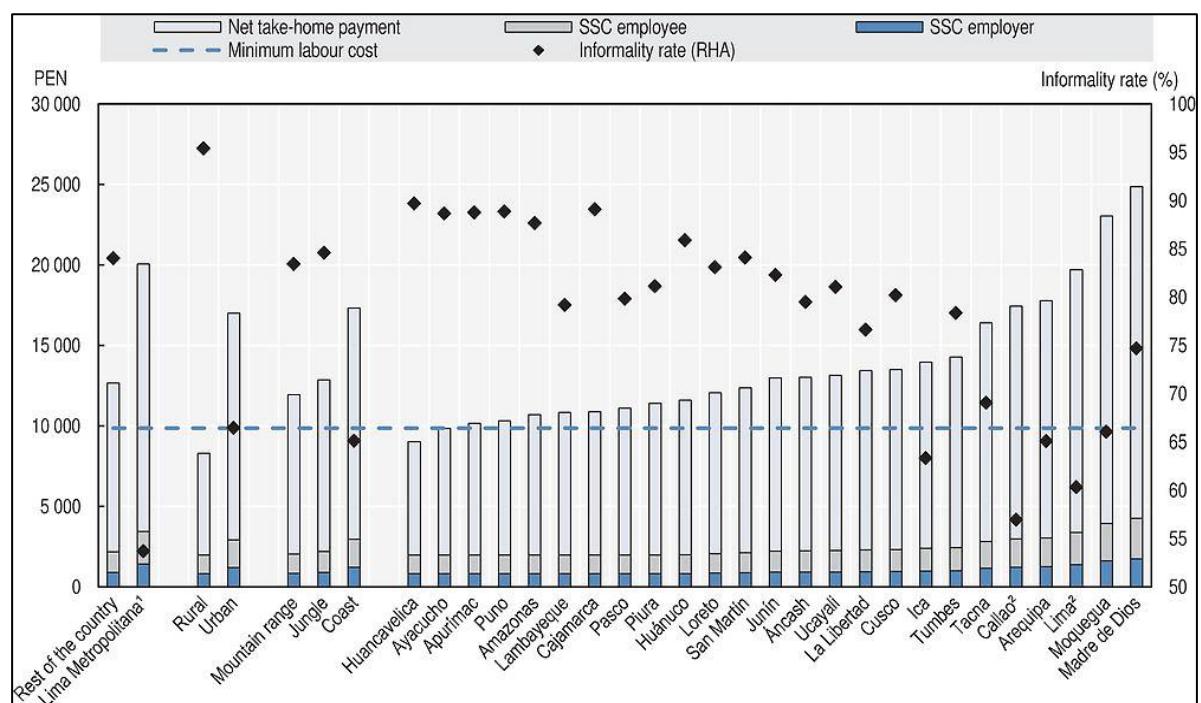


Figure 11 Total labour costs by geographic location in Peru

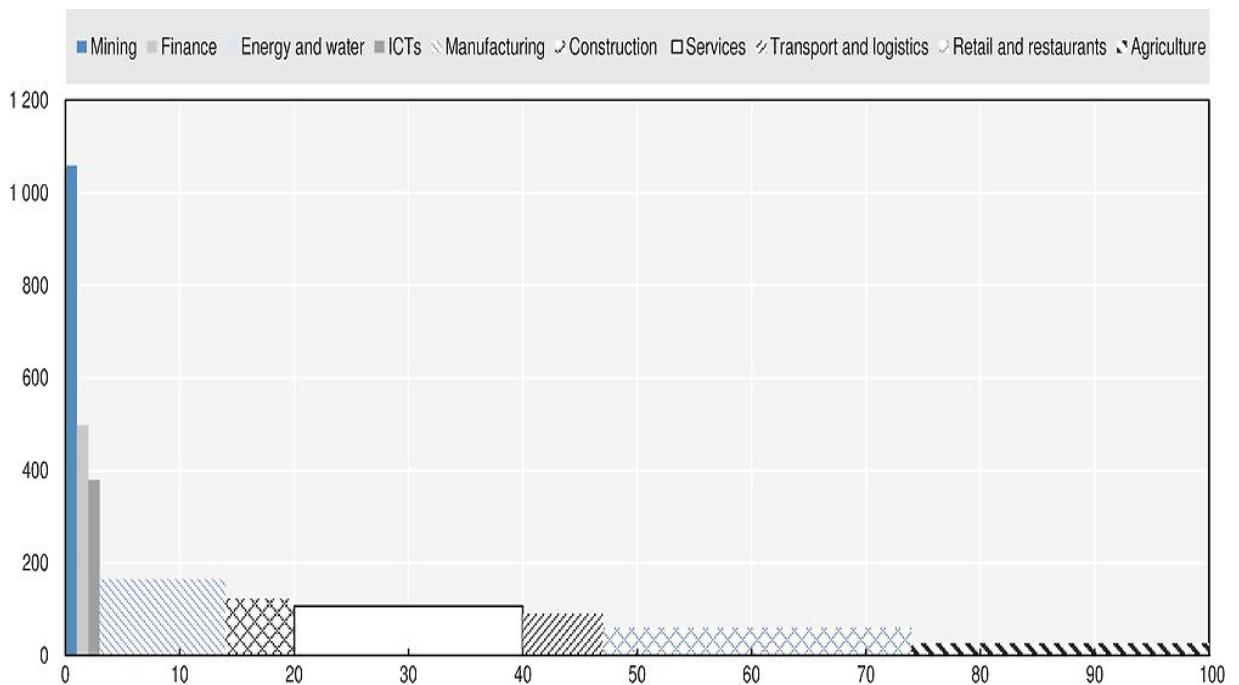
Source: *OECD calculations based on OECD/IDB/CIAT (2016), Taxing Wages in Latin America and the Caribbean and INEI (2014b) Encuesta Nacional de Hogares (ENAHO) (National Household Survey) (database).*

## **Peru's primary economic structure is not conducive to formal job creation.**

Informality is also closely related to Peru's economic structure, which is responsible for the country's low productivity levels. A concentrated economic structure in primary and/or low-productivity sectors that employ a substantial proportion of the population in low-quality informal labour restricts the expansion of formal employment. This is the economic structure observed in Peru, which corresponds to a dualist view of informality, which suggests that the informal and formal sectors are largely separated, with a large informal sector comprised of many uneducated entrepreneurs running small, unproductive firms that add little value to productivity and a smaller formal sector comprised of educated entrepreneurs running larger, more productive firms.

In Peru, employment is concentrated in low-productivity, informal industries, with few jobs created in more productive, formalized sectors. Labor productivity varies dramatically across economic sectors. Mining, banking, energy and water, and telecommunications have high labour productivity, but retail and restaurants and agriculture have particularly low productivity. Mining, in instance, was the most productive industry in 2013, with labour productivity more than ten times the Peruvian average and more than 40 times that of agriculture. However, the few economic sectors with high labour productivity, such as mining, employ only a small percentage of the workforce. In contrast, retail and restaurants, as well as agriculture, employ the majority of Peruvian workers yet have the lowest production levels. This indicates both the inverse link between productivity and informality in Peru, as well as the fact that the Peruvian economy is now unfavourable to greater formal job growth.

### **Labour productivity in Peru's economic sectors**



*Figure 12 labor productivity in Peru's economic sectors*

*Source: OECD calculations based on OECD/IDB/CIAT (2016), Taxing Wages in Latin America and the Caribbean, and INEI (2014b) Encuesta Nacional de Hogares (ENAHO) (database).*

The recent period of economic prosperity has just a limited impact on formality. However, the majority of informal job creation took place between 2002 and 2006. Informality varies by sector and geographical region, with a strong association with agricultural operations. Departments where agricultural sectors employ the vast majority of people have higher levels of average informality as well as lower levels of productivity and wage earnings, corroborating the notion that economic structure and productivity levels are important predictors of informality rates.

#### **4. Impact of Informal Economy on Economic Growth**

Of all economic issues, informality is one of the most gravely misunderstood. Including VAT, income tax, labor market obligations (like social security taxes and minimum wage requirements), and product market regulations, informal businesses avoid their

fiscal and regulatory responsibilities (including quality standards, copyrights, and intellectual-property laws). Evasion varies by industry and business type: informal retailers frequently forego paying value-added taxes, informal food processors frequently flout safety and hygienic standards, and informal construction companies frequently under report employee counts and hours worked.

It is true that the informal economy is largely comprised of small, traditional businesses with low levels of technology, scale, and standardization. For many people, the informal economy consists of street vendors and small businesses. However, it is not unheard of among larger, more advanced businesses in developing nations (Exhibit 1), where MGI has discovered unofficial supermarket chains, auto part suppliers, consumer electronics manufacturers, and even sizable industrial operations.

Every industry has different levels of informality. It is most prevalent in-service industries like retail and construction, where companies are frequently small in size and dispersed geographically, making it simpler to avoid detection. Auditors find it challenging to confirm revenues because they come from specific customers. Companies are tempted to under report employment because labour expenses account for a sizeable portion of total expenses. Construction workers in one nation fled job sites when government inspectors showed up, according to MGI.

Similar to how informality is more common in labor-intensive industries like apparel and food processing than in capital-intensive ones like auto assembly, cement, oil, steel, and telecommunications, informality is more pervasive in manufacturing industries. Even so, some very big manufacturing and industrial firms run on a more informal basis. For instance, in India and Russia, local governments compel local power companies to give free energy to a select group of businesses; these types of subsidies enable unofficial businesses to continue operating.

The informality is influenced by three things. The most glaring example is the ineffectiveness of judicial systems, weak penalties for noncompliance, and understaffed and dis-organized government enforcement agencies. The expense of operating formally is a second factor; excessive bureaucracy, high taxes, and expensive worker safety and product quality regulations all encourage businesses to operate in the grey market. Social norms also play a role in the issue. There is little social pressure to uphold the law in many developing nations. Some consider it acceptable for small

businesses to avoid paying taxes and following regulations in order to compete with the advantages of big, contemporary players.

As a result, the informal economy is expanding globally. For instance, it is said to be increasing in Sweden as some businesses look to avoid high taxes and onerous employment laws. It now employs 50% of non-agricultural workers in Brazil, up from 40% a decade ago. In many evolving nations, it is growing as a result of increased taxes and reduced budgets for government enforcement agencies, sometimes as a result of fiscal austerity measures imposed by the IMF and other foreign lenders.

#### Employment:

In emerging market and developing economies, the informal sector—labor and business that is hidden from monetary, regulatory, and institutional authorities—accounts for about a third of GDP and 70% of employment (of which self-employment is more than half). A sizable informal sector is linked to low productivity, decreased tax revenues, poor governance, excessive regulations, poverty, and income inequality, despite providing the benefit of employment flexibility in some economies.

It will be necessary to implement comprehensive policies that take into account country-specific circumstances to address the issue of pervasive informality. Measures aimed at lowering regulatory and tax burdens, increasing access to financing, enhancing education and other public services, and bolstering public revenue frameworks could all be implemented to promote long-term development.

The informal economy is thought to be counter-cyclical, meaning that it grows during recessions and shrinks during expansions in the economy. Recent analyses of data collected over time from various developing nations, however, point to a more complex and dynamic picture, with significant variation in in-formalization patterns between nations.

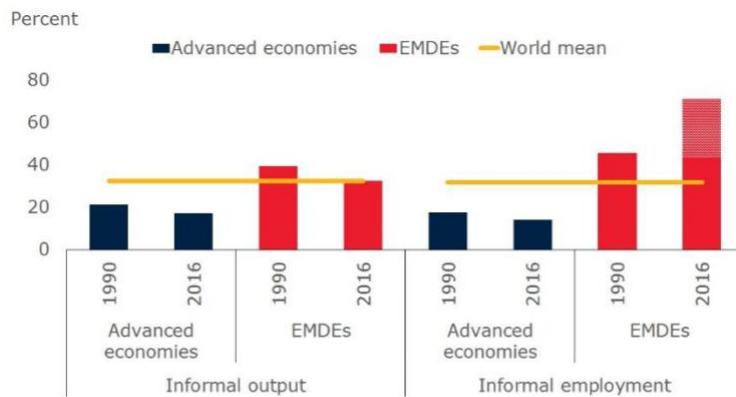
An increase in informal employment is correlated with sudden economic downturns. However, in some nations, steady economic growth is also correlated with an increase in the informal workforce. During economic downturns, some types of informal employment increase. These include both informal survival activities and subcontracted and outsourced activities caused by formal businesses attempting to weather the storm. When the economy is doing well, some other types of informal employment grow, such

as small businesses run by entrepreneurs and subcontracted and outsourced work related to the global production system.

Recently, three groups of economists examined the relationships between the rates of informality and growth at two points in time in various groups of countries: Rosanna Galli and David Kucera (2003) in 14 Latin American nations; James Heintz and Robert Pollin (2003) in 20 developing nations; Norman Loayza and Jamele Rigolini (2006) in 18 developing and 24 developed (high-income) nations.

Heintz and Pollin discovered that informalization increased in the majority of developing nations (14 out of 20); four saw a decline; and two saw little to no change. In three nations with respectable per capita growth rates (>2%), informalization grew, while it decreased in two nations with subpar per capita growth rates (1%). Even in nations with high rates of growth, these patterns imply that informal employment has been growing more quickly than formal employment (Heintz 2006:17). Higher rates of growth are typically correlated with slower increases in the rate of informalization, according to the authors' conclusion. If growth is very rapid, informality may decrease (*Ibid*:18; Heintz and Pollin 2003). But they also point out that not all forms of informal employment are included in these cross-country comparisons; in particular, the data frequently leave out own account production and informal wage employment, particularly industrial outwork. Increases in certain types of informal employment, most notably industrial outwork for global supply chains, may be linked to high levels of growth fueled by export production (see evidence from Tunisia).

The world's developing and emerging market economies account for 95% of informal employment and 50% of all informal output. Since 1990, both informal output and employment have decreased, especially in nations with higher output growth, quick accumulation of physical capital, and greater improvements in governance and business climates.

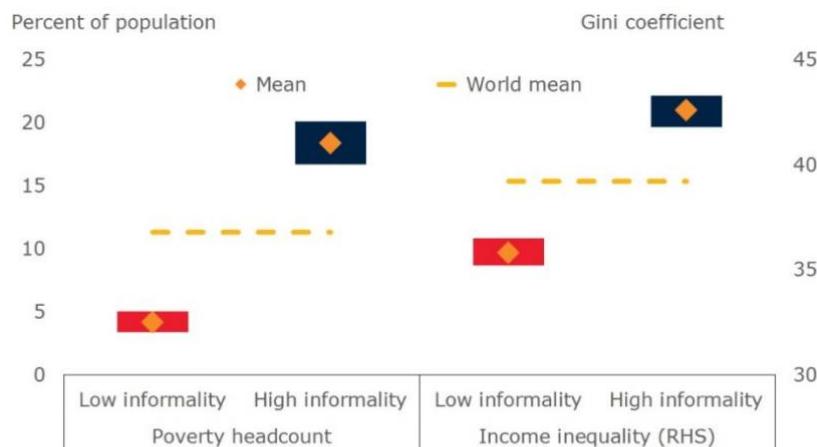


Source: Elgin et al. (forthcoming a); International Monetary Fund, World Economic Outlook; International Labour Organization; World Bank, World Development Indicators.

Note: Unweighted averages. Informal output are in blue (in percent of official GDP). Informal employment (in red, in percent of employment) uses self-employment shares (with additional informal employment shares in shaded red) in the closest (latest) available year around 1990 and 2016. World averages between 1990–2016 are in yellow. EMDEs= Emerging market and developing economies.

*Figure 13 informal output in advanced economies vs. EMDEs*

Lower-skilled and less productive workers are more prevalent in the informal economy. As a result, those employed in the formal economy make an average salary that is roughly 19% higher than those employed in the informal economy.



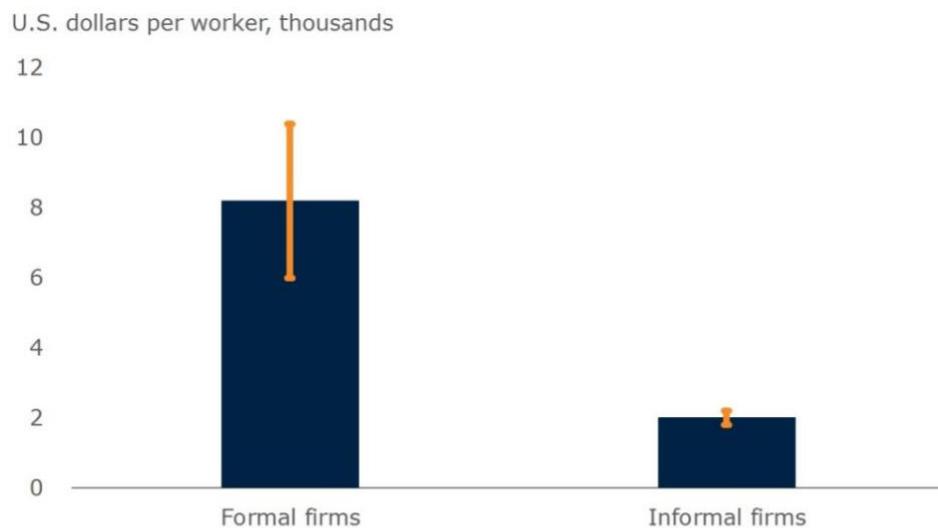
Source: Elgin et al. (forthcoming a); World Bank, World Development Indicators.

Note: Data are for 1990–2016. Group means (diamonds) and 95 percent confidence intervals (bars) are shown for poverty headcount ratio at \$1.90 a day (2011 PPP, percent of population) and Gini coefficients. "High informality" ("Low informality") indicates countries with above- (below-) median informal output (DGE-based estimates).

*Figure 14 Informality, poverty, and income inequality*

In emerging market and developing economies, the average informal firm is only 25% as productive as the typical firm operating in the formal sector. Informal firm characteristics like their younger age, less experience, and smaller size can only partially account for this. Additionally, formal sector businesses that deal with informal

competition produce, on average, only 75% as much as those that do not. Some of these productivity disparities can be lessened by improved business environments.



Source: World Bank.

Note: World Bank's Enterprise Survey data for 135 countries (2008-18). Labor productivity is proxied by the annual sales in 2009 U.S. dollars per worker. Bars show the estimates, with the corresponding +/- 2 standard errors shown in whiskers.

*Figure 15 Average productivity in formal and informal firms*

### **The negative effects of Informality**

In two different ways, informality stifles productivity and economic growth. The first is that businesses are kept small and unproductive by the strong incentives and dynamics that bind them to the grey economy. Second, by saving money by avoiding taxes and regulations, informal businesses are able to overtake larger, more successful formal competitors in terms of market share. Furthermore, the negative effects of informality aren't just economic; they also have social effects.

- **The trap of low productivity**

Academics, development specialists, and government officials frequently claim that as the formal sector expands and society becomes more formalized, informality will decline. However, according to MGI research, informal businesses are forced to engage in menial, ineffective, low-productivity work as a result of becoming entangled in a

self-reinforcing dynamic. This study demonstrates that they operate globally at a productivity level that is only half that of formal companies in the same industries on average, and at a productivity level that is only a small portion of the productivity of the best companies. When a company chooses to operate informally, it loses its ability to finance expansion and make investments to enhance operations.

Since many informal businesses lack legal status, they frequently turn to illegal moneylenders who charge exorbitant interest rates and only advance small sums of money as opposed to formal credit institutions. It is risky for informal businesses to conduct business with individuals or entities outside of their immediate community because they cannot rely on the legal system to uphold their agreements, protect their property rights, or settle disputes. Additionally, operating shadily creates perverse disincentives for growth because a bigger business might draw more government attention.

Additionally, informal businesses frequently structure their supplier and customer relationships in a way that makes it challenging to later act legally; for instance, informal retailers frequently purchase goods from informal producers. To enforce agreements and provide funding to members, unofficial businesses will occasionally form voluntary associations, further entrenching the grey economy. The production and distribution of clothing in India, soft drinks in Brazil, and groceries in Russia are just a few examples of industries and nations where entire informal value chains outperform their formal counterparts on a nearly insurmountable cost basis.

Customers of an informal business also come to expect very low prices, and many would seek out alternatives if it decided to become a formal business and had to raise them. Therefore, it is a myth that informal businesses could expand and merge with the formal economy. Instead, they pass up chances to modernize and are stuck in low-productivity processes. The efforts made in the late 1990s by Migros Turk, Turkey's largest grocery retailer, to group independent grocers under a single brand that would have given them more purchasing power and operational support, are the best illustration of this issue.

Few people joined because, despite the benefits, they had to fully adhere to the plan's tax and social security requirements. Thus, unofficial players continue to lower a nation's overall productivity and standard of living. For instance, informality

contributes to nearly 50% of the global productivity gap with the United States in Portugal and Turkey.

- **Limiting Legitimate Businesses**

By preventing bigger, more effective formal companies from gaining market share, informality also stunts economic growth. Avoiding taxes and regulations has a cost benefit that frequently exceeds 10% of the final cost. Due to this advantage, informal businesses are free to undercut their formal competitors and stymie the normal competitive process, in which more productive businesses gain market share and displace less productive ones, despite their low productivity. Formal businesses are at a disadvantage throughout the developing world.

By underpaying taxes and purchasing goods from unlicensed vendors, informal food retailers in Russia are able to sell their products for an estimated 13 percent less than supermarkets. According to MGI, even if these retailers followed the law, they would still be 5 percent more expensive than contemporary supermarkets. Thus, informality hinders supermarkets from increasing their market share and deters big-box retailers from investing in new technology and best-practice operating techniques. Because of the unjustified cost advantage, formal supermarkets in Brazil have discovered that they cannot profitably acquire informal players.

Although supermarkets could boost the productivity of the businesses that were acquired, their small size causes net margins to zero after taxes are paid (Exhibit 3). Turkish dairy processors save almost 20% on costs as a result of informality, which allows them to continue operating despite having low productivity. Informal software businesses in India steal innovations and copyrights without having to pay for them, cutting into the profits of established businesses. The industry's productivity and profitability would increase by nearly 90% if software piracy rates reached US levels. Since governments receive significantly less tax revenue as a result of widespread informality, they are forced to raise the tax rates imposed on formal businesses, which further slows economic growth. Higher rates not only magnify the unearned cost advantage of informal businesses, but also limit the amount of post-tax money that formal businesses can use to invest in techniques and technologies that boost

productivity. High taxes encourage businesses to operate informally, which increases the tax burden on the remaining formal businesses, which already pay more than 80% of the taxes in most developing countries. This dynamic helps to explain why, despite a decade of economic liberalization and reform, the informal economy is expanding in Brazil.

- **The Societal Cost**

Given their level of economic development, the majority of developing nations offer generous social security programs and labour laws. The issue is that only a small portion of them—public sector employees and formal businesses—are covered by these provisions. The vulnerable workers in the informal economy generally make less money, have less access to health and safety protections, and have fewer unionization opportunities. Additionally, consumers have fewer options. In developing nations, people can typically choose between purchasing very expensive, high-quality goods and services similar to those found in wealthy nations or inexpensive, low-quality goods and services from unofficial businesses—often without being fully aware of the risks and hazards. There are no products or services geared toward the middle market.

Customers might only have the option of purchasing ultra-safe pasteurized milk or unpasteurized milk, opulent homes or shanties, pricey modern shopping malls or tiny mom-and-pop stores, pricey Western cars or motorcycles and bicycles, etc. Small and medium-sized businesses that could create goods to satisfy middle-market consumers' needs are typically informal and lack the capacity and incentives to do so.

### **Long term positive effects:**

In the long and short term, the informal economy's impact on the formal economy may be asymmetrical due to two opposing theories:

- First, the informal economy, which is larger and more dynamic, is seen as a safe haven for illegal production and employment because it can operate outside of the law and bureaucracy. When savings and income from the informal sector are used to buy goods for consumption made by the formal economy, this may

help the economy over time. Furthermore, the informal sector may be used as a replacement for social security in nations with weak social welfare institutions and a relatively high incidence of poverty.

- On the other hand, informality burdens the exchequer, especially in terms of short-term revenue collection; as a result, it restrains formal economic activity by increasing the cost of being formal, meaning that taxpayers must pay the price of tax evaders. Lower tax revenue means less money spent on public utilities, which results in lower economic growth and productivity.

It is expected that the informal sector will have a significant negative impact in the short term. Because of tax evasion, which increases the tax burden on the official sector and has a negative impact on public utility spending, taxation, productivity, and short-term economic growth, the informal sector is a burden to the formal economy.

The fact that the informal sector acts as a safety net for the poor in developing and transition economies—which is highly likely in a developing country with a growing population but a weak social protection system—is what ultimately causes it to have a positive impact on the growth of the formal sector's economy. Many rural areas in these nations lack access to basic amenities and have high unemployment rates. Because it can avoid bureaucracy and legal requirements, the informal sector, which is larger and more dynamic, is seen as a safe haven for informal employment and production activities in the long run. When savings and income from the informal sector are used to buy regular consumer goods made by the formal economy, this may help the economy in the long run. Furthermore, the informal sector may be used as a replacement for social security in nations with weak social welfare institutions and a relatively high incidence of poverty.

Since it weakens the accuracy of national accounts statistics and has an unintended impact on economic policies, the informal sector is viewed as a nuisance. In addition, by paying taxes and license fees, the official sector is also supporting businesses and workers in the informal sector. Contrary to popular belief, the informal sector, which is unencumbered by bureaucratic formalities, has the flexibility to adapt to changing economic conditions and may even stimulate economic activity. This is demonstrated by the informal economy's positive long-term effects on the formal economy.

Furthermore, policies to control this sector must be carefully crafted due to the informal sector's variable effects on the formal economy over two time horizons. Most importantly, it is necessary to reduce the cost of formality along with the elimination of systemic corruption, as doing so will raise the cost of informality. Tax amnesty programs for seasoned tax evaders, eased payment terms for land squatters, and other initiatives increase the chances that concerned officials will accept bribes, which, once institutionalized, raises the cost of formality. Therefore, it might be appropriate to think of institutional value reforms as the first step before taking action against the informal economy.

### **Impact of informal economy on Peruvian economic growth:**

Recent studies estimate that the informal economy accounts for 34% of the GDP on average in Latin America, while it accounts for 19.83% of the GDP in the OECD countries, or slightly less than half of the average. Institutional effectiveness and the level of economic development in each country account for the differences between those groups of nations. Peru, which accounted for 37.4% of the region's GDP in 2016, and Turkey, which accounted for 29.75% of the OECD countries' GDP during the same period, are the two nations with the highest levels of informality. Furthermore, Denmark has the lowest informality in the OECD countries, at 12.84%, while Uruguay has the lowest in Latin America at 14.47% for the year 2016. According to Hassan and Schneider's results for 2013, Peru's informal economy had a size of 60.9%, which is roughly half of what was predicted in the current study. The 17.3% estimate provided by the INEI (2016) indicates a figure that is roughly one-third that of Schneider. Finally, although the trend is the same in both cases, this research's proportion is slightly less than the INEI's estimate (INEI and the present research). According to Hassan and Schneider (2016), Bolivia (66.04%) and Honduras (72.41%) have the largest informal economies, followed by Mexico (31.19%) and Greece (39.39%). The fact that Hassan and Schneider included the demand for money as an indicator in their model with the assumption that an excess of demand over supply is caused by informality, but it may also be explained by the existence of illicit activities that demand cash, is one explanation for the large number in their results. According to the findings, the size of

the informal economy has had a negative impact on tax collection in Peru, Latin America, and OECD nations. In Latin America, the informal sector has been reduced by policies implemented since 1995, with an average reduction from 34% to 31.4% between that time and 2016. In contrast, it stayed at 20% for OECD nations throughout the years of research. It is clear from both instances that policies to reduce the informal economy, like lowering taxes and removing obstacles to formalization, have not been effective. These findings paved the way for additional lines of inquiry into what drives people to remain in the informal economy and what drives them to reject formality. Since the GMM 3SLS estimation demonstrates that the informal economy has a favourable impact on economic growth in Latin America, De Soto's (1980) claims about informality as a source of entrepreneurship are supported. The OCED countries, on the other hand, may experience a detrimental effect. The informal economy reduces the amount of taxes collected in countries throughout Latin America and the OCED. Even though the informal economy exists in all nations, it is more prevalent in developing nations, and its fixed effect persists in every nation. As a result, solutions cannot be universal and must take into account cultural and idiosyncratic variations. Policies like lowering taxes or lowering barriers to formalization are not solutions on their own. The institutional setting, which includes the government, plays a significant role in whether the informal economy grows or shrinks. It is less likely that the informal economy can be reduced if institutions do not want to become more effective, transparent, and committed to people's welfare. In order to completely eradicate corruption at all levels of the economy, the institutional problem must be resolved. In a similar vein, laws and regulations must be followed regardless of the subject, in addition to being clear to prevent unfair application. Additionally, there is a direct correlation between self-employment and unemployment and informal employment, which fills the gaps left by formal employment in terms of hiring. Because a nation with greater inequality would likely have a larger informal economy, the Gini coefficient is a significant indicator. It is well known that MIMIC model controversy exists. Although the adjustment procedure could be calibrated using the INEI's initial study on the informal economy in Peru in order to better improve the goodness of fit after obtaining the slope of the informal economy by using the Multiple Indicator Multiple Cause method. The MIMIC model has also been criticized for its inability to completely

distinguish between illicit and informal activities because the former groups conceal their income. Finally, because the model requires a substantial amount of data, it is not feasible to analyse just one nation.

Following an extensive review of the research, some conclusions can be drawn. First and foremost, a stronger theoretical foundation is required to comprehend the behaviour of agents in the informal economy. Second, it is not possible to come up with a singular solution (a recipe); instead, we must tailor the potential solutions to the unique causes of the informal economy in each nation. Thirdly, all agents (including the government, institutions, formal and informal sectors, as well as individual agents) must be taken into account because different behaviors have different effects on the informal economy's size. Fourthly, it is probably more important and effective to consider factors that affect the perception of social welfare, the elimination of corruption, transparency and efficiency in government spending, and education when attempting to reduce informality than tax reduction programs. Along with fostering and maintaining economic growth, a comprehensive set of formalization policies must be taken into account. Last but not least, it is important to realize that the outcome won't be apparent right away.

From the perspective of public management, attempting to solve the issue entails combining the viewpoint of the social actor with that of the rational economic actor in order to determine whether an agent's participation in the unofficial sector is caused by a low moral tax or by what is known as the civil morality (Williams, Horodnic, & Burkinshaw, 2016). In this situation, regardless of the other policy measures the state may take, the best way to address the informality issue would be to encourage tax morality. However, for this to occur, governments must strengthen, advertise, and communicate the institution of "state morality" (not just through laws, but also through their actions) (Williams, Horodnic, & Burkinshaw, 2016, p. 368). The moral obligations of the state are addressed by this state morality. In order to put this idea into practise, Williams' (1923) theory must be adopted when defining a conception of the state: a group of people who are socially unified; second, a political apparatus called a government that is run by a group of officials known as the magistracy; and third, a set of laws or maxims, whether codified or uncodified, that specify the parameters of this public authority and how it should be used. Education is one way to raise state morality

as well as civic morality, which includes tax morality. Additionally, it is important to realize that informal workers are not criminals and that informality should be examined in light of two fundamental, but frequently overlooked, facts: first, Peru's informal economy is heavily influenced by social and economic inequality; second, it is a mechanism for the capitalist development of an enterprise that, if properly managed, could help spur economic growth. From this vantage point, government policies must consider informal workers as entrepreneurs who, in the majority of cases, require education, social protection, financing, technology, and skill improvement to develop their businesses (Lupi, 2018). This is where management science can assist informal organizations in realizing their full potential.

## **5. Policy Responses Towards Informality**

The informal economy's complexity and heterogeneity make it difficult for policymakers to handle the issue. Policy reactions to informality differ a wide range of punishments, ignorance, and even support. It is mostly determined by the informal actors' perceived motive (voluntary versus involuntary), which can range from "intentional evasion of regulation and taxation" to "cushioning" during economic downturns" or "source of income for the excluded poor."

Whatever the cause, informality burdens state budgets and social security institutions through lost revenues, it excludes a number of workers from the protection of labour law, and it weakens work standards, all of which violate the four pillars of decent employment (ILO 2013a). Informality creates unfair competition among enterprises, undermining productivity and economic performance. Although some see it as a temporary growth engine in times of crisis due to its flexibility, many researchers agree that a high degree of informality reduces an economy's competitiveness because informal firms tend to stay small, have less access to inputs, and cannot engage in formal business relationships - factors that reduce their productivity (OECD 2009).

As a result, there is broad agreement among policymakers on the importance of facilitating the transition from the informal to formal sector. The goal of transition is evident, but the question of "how" is still debatable and varies greatly from situation to

context. In most cases, the essence of transition is essentially about improving current jobs and working conditions through firm expansion and productivity increases. The 2030 Agenda for Sustainable Development recognized that the transition from informal to formal economies is critical to attaining inclusive development and decent work for all, particularly through the fulfillment of Target 8.3. This Target aims to promote development-oriented policies that encourage productive activities and the creation of good jobs, as well as to boost the formalization and growth of micro-, small-, and medium-sized businesses, including through access to financial services.

The 2015 ILO Recommendation No. 204 on the transition from the informal to formal economy encourages all members to develop a road map for formalization. The advice clearly recognizes the need for a balanced strategy combining incentives and compliance measures, as well as coherence and coordination across a wide range of policy areas in order to facilitate the transition to the formal economy. The methods mentioned in the Recommendation are kept broad in order to address various causes of informality (voluntary/by choice vs. involuntary/by necessity), combining preventive efforts, law enforcement, and effective punishments.

Among the actions indicated are the definition and assessment of informality, a review of legislative acts (such as labour law, tax law, and social security legislation), and policy actions for skill development, employment, entrepreneurship, and social security coverage (ILO 2015).

### **Legislative reforms for formalization**

### **Institutional change with limited success**

Through various initiatives, the Peruvian government has worked to address the socioeconomic issues generated by the informal sector. Governmental policies, However, these measures have obtained only modest success As already stated, Informal employment had previously decreased only by seven percentage points from 2005 to 2012 (Thorne). And this decrease was achieved against the backdrop of a number of favourable factors and extrinsic influences, most notably a favourable economic environment cycle that widened the labour market.

One institutional development was the 2007 implementation of the e-payroll system.

Businesses with three or more employees were required to provide certain tax information to SUNAT (FORLAC), the country's tax authorities. This system's deployment made it easier to monitor and enforce tax and labour requirements, and it helped to register 340,000 jobs, an estimated 276,000 of which are new structured ones (FORLAC).

Peru has also acknowledged the need for regulation to especially encourage the formalization of micro and small enterprises (MSEs), due to the disproportionately high informality experienced by MSEs. The Single Streamlined Regime, which allows small firms to pay a monthly set sum in place of filing tax returns, simplified tax regimes for MSEs. In general, these businesses avoid paying income, sales, and municipal taxes. Furthermore, the Special Income Tax Regime for MSEs allows for the payment of a monthly sum based on net income at a rate significantly lower than the corporate rate of 30%. (FORLAC).

The purpose of these programmes is to reduce the tax burden on MSEs, so removing a major obstacle to formalization, and eventually broaden the tax base. Despite these well-intended efforts, informality has not decreased significantly. Only 5% of Peruvian MSEs were properly registered in 2011. (FORLAC).

### **Shortcomings of Peru's Current Approach**

Alfredo Thorne, Peru's former finance minister, outlined an ambitious plan to shrink the informal economy in 2016, aiming to reduce it to 30% of the labour force by 2021. Thorne's reform approach has three reform pillars:

- Lowering formalization barriers
- Improving quality and access to public services
- Developing pro-formalization regulatory policy.

Although the plan includes many strong, comprehensive ideas, it falls short in certain critical areas.

Thorne listed tax and administrative simplification, higher-quality worker protection, and greater finance availability as major governmental objectives for reducing barriers

to formalization. Tax simplification strategies would propose new tax systems to encourage further formalization. Former President, Pedro Pablo Kuczynski, declared in September 2016 his intention to decrease the national sales tax (VAT) from 18% to 17% in order to encourage informal enterprises to register with the state (Post, "Peru Govt...").

Kuczynski recommended raising Peru's corporate tax rate to compensate for the lost revenue. However, while lowering VAT may lower registration barriers, raising corporate tax rates would have the opposite effect. A rise in the corporate tax rate may reduce the tax base by making it more expensive for firms to stay formal and hence opt out of paying taxes entirely. Many components of Thorne's proposal aim to encourage workers to enter the formal sector. Thorne supports expanding the coverage of health services and enhancing the quality of education to increase human capital within the framework of better quality and access to public services.

Thorne's plan involves the implementation of a pro-formalization regulatory policy. He suggests establishing a National Council for Competitiveness and Formalization to develop policy measures that will promote formalization. These reforms could include business training, institutional strengthening, increased access to credit, and improved rule of law. Many Micro and Small Enterprises (MSEs) confront a limited and expensive source of finance, with interest rates often ranging from 20% to 33%. Greater access to lower-cost funding will encourage formalization.

Many of Thorne's policy initiatives are comparable to those that other countries in the area have successfully implemented. Thorne's plan, however, does not address altering Peru's onerous labour standards, which are a substantial hurdle to formalization. "Victor Zavala" of the Lima Chamber of Commerce (Post, "Peru's Formalization...") stated,

*"Today, it is easier to close a business than to fire an employee."*

If Peru is to drastically shrink its informal sector, labour restrictions must be relaxed.

## **An Integrated Approach**

Many of the policies put in place over the last decade have failed to significantly address the issue of informality. This could be because the reforms were not integrated and were instead designed to address various issues, resulting in an ineffective overall impact. A Heterogeneous approach to legislative change, which has proven successful in many other nations, is the solution.

Peru must implement a comprehensive package of adjustments to achieve two goals:

- (1)reduce barriers to formalization for informal workers and businesses
- (2)offer adequate incentives to attract persons and businesses to the formal sector.

These two objectives might be thought of as minimizing the push factors of formalization while enhancing the pull aspects.

Peru's business tax policy, as previously noted, is a major driving force. Many small businesses lack the resources to prepare, file, and pay all obligatory government contributions and taxes. As a result, many countries have benefited from taxation reform for MSEs, which lessens the barrier to formalization by lowering the amount they pay in government payments. Such reforms have included measures to both lessen the tax burden for non-compliant taxpayers and encourage compliance. The former goal can be met in Peru by lowering the corporate income tax, offering tax breaks in industries with a significant proportion of informal workers, and instituting tax breaks for low-wage earners. Policies should simplify the tax structure for SMEs and eliminate overlapping payroll taxes to encourage compliance, making it easier to file and pay. The purpose of this reform is to recoup more of the government's lost revenue owing to tax evasion. This would improve government revenues, resulting in less fiscal borrowing, smaller budget deficits, and lower inflation rates. Furthermore, with the potential for increased spending on public welfare programmes, such tax measures would aid in the reduction of income inequality. Compliance with tax rules may make it easier for businesses to acquire capital to expand. Because businesses must have good accounting records, they will be able to show collateral and the ability to repay debt, allowing them to acquire loans.

However, tax reform alone will not suffice to lower the number of informal businesses; the tax administration must also address efficiency and enforcement difficulties. This is because an unequally enforced tax regime, such as one that provides tax breaks to major corporations in exchange for political support, will perpetuate economic inequality and push smaller businesses into the informal sector. Peru's eastern neighbour provides an example of successful tax reform. Brazil introduced the Integrated System of Taxes and Contributions for Micro and Small Enterprises in 1997, which replaced six different forms of federal taxes and five different types of social security contributions with a progressive tax based on gross revenues. This scheme connected social security contributions to a firm's revenue rather than the number of workers employed; as a result, it reduced the cost of hiring another person, removing the incentive to hire informally. As a result of this campaign, Brazil saw a 10% to 30% increase in the number of enterprises registered.

Legislative policies aimed at lowering formal entry barriers should also address onerous labour regulations. The World Bank made recommendations to Peru in 2015 to boost productivity and sustain economic growth. Its analysis highlighted the informal economy as a major hindrance to long-term growth and advised that Peru, most critically, relax labour restrictions. According to World Bank official John Panzer, "[More flexibility for employers] will drive the informal sector to join the formal sector, because it gives greater access to financing, resources, and state backing" (Post, "World Bank..."). He also adds that "restrictive laws governing employee termination impede firms from hiring new staff." As a result, informality increases and productivity decreases" (Post, "World Bank...").

Peru may discover that allowing firms to hire and fire workers more readily are the ideal place to start in order to reduce the burden of regulation. Peru might begin by abolishing laws that prohibit layoffs and extending the concept of "just cause" for dismissal in order to increase hiring and firing flexibility. It should, in particular, make it easier for businesses to modify their workforces over different economic cycles, as well as encourage part-time and temporary contracts for unemployed workers.

Addressing tax policy and labour legislation will help to offset some of the costs of formalization, but more steps must be taken. One impediment to formalization is the

difficulty in registering a small firm with the state. The lack of transportation between Lima's slums, where their company was located, and the city, where the registration facilities were located, was a major hurdle to registration for de Soto's team of economists. Peru might alleviate this strain by opening registration offices in a number of important neighbourhoods. The Ministry of Labor might also place officials in those locations to immediately assist with legalization and to ease the time-consuming process of registering with the state.

Furthermore, as an incentive to formalize, the Peruvian government should consider granting regularization loans to small firms. Many MSEs suffer due to a lack of funding and formalizing their firm may cut into their already meagre profits. Offering broader and lower-cost loans to enterprises that can demonstrate 100 percent formal worker engagement would allow these businesses to access the capital they badly need to develop. For Example, Brazil experienced success with its Bolsa Familia program, which merged municipal, state, and federal government income programs and grew to become the country's greatest wealth transfer and poverty-fighting programme. The program combated social inequalities while also empowering families by allowing them to exit informal job situations.

Finally, strong social programs are frequently used as a carrot to incentivize informal players to accept the government's rule of law. They also aid in the redistribution of income to the weakest segments of society, hence reducing income inequality. Peru can encourage labour force participation through training small-scale entrepreneurs in the technical skills required for success. Peru might potentially address gender inequality in informal participation by offering women gender-specific training. For Example, Sri Lanka was successful in pursuing a similar strategy by launching a training programme that provided technical skills to informal workers through both private and public training institutions. Chile went even further, fining informal sector business owners for noncompliance with training requirements.

International experience shows that when a government prioritizes informality and addresses it through broad reform, significant progress can be achieved. If Peru does

not reduce the size of its informal economy, it could become a major drag on the country's economic future.

### **Other Policy Recommendations**

In most developing countries, informal companies account for a significant portion of the economy. Expanding formalization could enhance government tax revenues, firm profits and national income, and employee well-being through expanding access to social security, health care, and workers' compensation. Reforms to encourage enterprises to register to include streamlining procedures, lowering registration costs and times, and making more information about registration procedures available. Reforms may or may not result in increased registration and formalization. In some circumstances, more enforcement and broader development strategies may be required.

### **Improving skill levels is essential for breaking the cycle of low productivity and informality.**

Improving the productivity of the informal economy is critical for developing-country employment, income development, and poverty alleviation. Many factors influence productivity, ranging from access to money, infrastructure, and a business-friendly climate to the quality of human capital, which includes labour-market-relevant skills (World Bank 2013). As previously stated, research point to the limited skill levels available in the informal economy, the lower education of informal workers, and the strong relationship between education and other labour market outcomes. This demonstrates the significance of informal sector skill development for enhanced productivity and profitability. Access to basic education and literacy may open the door to post-secondary education and motivate one to improve one's abilities and productivity through training from many sources.

Millions of women and men around the world continue to learn and work in the informal sector. Protecting and increasing the quality of training, products, and services can significantly contribute to increased productivity, local market development, and better working conditions, circumstances and job opportunities, transition to the formal sector, consumer protection, and Community social cohesiveness.

Because of a lack of knowledge, financial resources, and occasionally awareness, many workers in the informal economy do not have access to formal certification. Some trade unions representing workers in the informal economy have identified the value of skills evaluation in promoting the minimum wage for their members, improving working conditions, and increasing access to jobs.

Due to a lack of opportunities for skill development in formal education, the informal sector is forced to step in and supply young people with skills and job training. Indeed, many young individuals (including some upper secondary and higher school graduates) begin their careers in the informal sector by gaining on-the-job experience or completing an apprenticeship (Walther 2011). As a result, the majority of workers in the informal economy, who frequently lack access to formal education and training, acquire knowledge and skills through other means, regardless of where or how they were acquired: at work, in the community, at home, through informal apprenticeships, or learning by doing. Indeed, many private training providers, even unlicensed, informal operators, contribute to skill development and fill the need.

The ability to absorb and gain from education and training is well recognized, to begin with, a solid foundation of formal basic education. Learning cognitive and non-cognitive skills in primary and lower secondary education is a requirement for obtaining technical skills that prepare people for secondary and post-secondary education-required jobs. Because skill development is a cumulative process, this foundation is also vital for ongoing re-skilling and upgrading of workers later in the life cycle (World Bank 2013). While boosting basic education is vital to creating the foundation for subsequent skill development, supplementary initiatives must address the vast stock of people already in the informal economy.

As a result, every approach to boost productivity and revenue in small firms and family enterprises must consider the underlying causes of skill shortages.

In the informal sector, there are different constraints to skill development:

- Low levels of education as well as poor investment in basic education and high illiteracy rates keep many in the informal economy excluded from the mainstream economy
- unequal access to training;
- underdeveloped markets

- and a lack of attention from public training providers to the needs of the informal economy
- inadequate awareness about the benefits of training Market for skills
- limited supply catering
- inadequate economies of scale = higher unit training costs
- High training opportunity cost
- inadequate financial flow to pay for training Firms' and individuals' training costs.

Only by recognizing and addressing these limits can policies that engage small businesses and informal economy workers in developing a skills base for increased productivity and income be implemented.

Improving the education system is critical for increasing labour productivity and earning potential. Policies boosting human capital investment, such as lowering the cost of education and providing financial security to a household with limited finances put aside for education, attempt to break the feedback loop of informality with poverty and low labour productivity. In the long run, human capital development, such as education, can serve as leverage for societies to increase their global competitiveness.

### **A more diversified economy can encourage the creation of formal jobs.**

The observed relationship between informality and productivity levels, as well as Peru's economic structure, indicates productive diversification as a significant policy area for promoting more formal positions in the medium to long term. Efforts to promote more formal employment creation should be integrated into long-term planning, with a strong connection to the broader national development strategy. Creating formal jobs necessitates the promotion of an economy that has people with greater levels of productivity and skills on the supply side and can create good-quality formal positions to absorb those workers on the demand side. This will have to be linked to the overall development strategy and product diversification strategy.

Expanding economic diversification is required to promote formal job creation, increase productivity, and provide equal opportunity for all Peruvians. Several policies aiming at increasing economic diversification should have a positive impact on the

labour market. For example, market regulations aimed at encouraging entrepreneurship may result in more formal jobs and the consolidation of new enterprises and activities in Peru. Furthermore, changes in the allocation of commodity-based transfers based on the level of development of Peruvian departments, as well as investment in broad-based policies to boost competitiveness, should help formal jobs.

A large number of national strategic plans have been produced in this approach, with some referencing the need to minimize informality and generate formal positions including Plan Estratégico de Desarrollo Nacional Actualizado: Perú Hacia el 2021. A key goal of Plan Estratégico is to improve economic diversity, increase qualified workers, and reduce informality.

### **Tax regimes for SMEs can be improved to provide incentives to become formal and grow**

In Peru, the majority of SMEs are informal, and they face unique challenges in becoming formal. Formalization costs, such as those associated with taxes and the associated bookkeeping and filing procedures, can be particularly difficult for SMEs to overcome, given their limited size, capacity, and revenues. Governments have adopted special simplified tax regimes with narrower tax bases in an effort to bridge the barriers faced by SMEs, with the goal of encouraging formalization through cost reduction and ease of compliance. Tax compliance costs for a business adhering to special taxation regimes average PEN 915.80 (Peruvian soles), which is a significant reduction from PEN 7 489.00 for firms adhering to the general tax regime. These measures address the cost of tax compliance and, to some extent, special regimes have reduced efficiency barriers for firms, but they do not generally improve labour inspection capacities or address other regulatory hurdles.

Peru has several tax regimes aimed at a similar base, which are frequently redundant and favour certain occupational Regimes. For SMEs, there is a general regime and two simplified special tax regimes. Since 2004, the single simplified regime (RUS) has been in effect. RUS is a presumptive tax regime open to individuals and sole proprietors that encourages small producers and retailers to become formal by charging a small monthly fee based on annual sales of less than PEN 360 000 and assets of less than PEN 70 000.

As a benefit, these SMEs are eligible to enrol in and use Comprehensive Health Insurance in exchange for a single, flat monthly tax ranging from PEN 20 to PEN 600. The income tax regime is the second special regime for SMEs (RER). It is applicable to small producers with sales of less than PEN 525,000, assets of less than PEN 126 000, and fewer than ten employees. Firms are liable for 1.5% of net profits under this regime, compared to 28% under the general corporate taxation regime.

<b>Tax regimes for individuals or firms with businesses in Peru, 2016</b>			
	<b>RUS</b>	<b>RER</b>	<b>General Regime</b>
<b>Scheme description</b>	A tax regime created for small retailers and producers, which replaces payment of various taxes, allowing them to pay a fixed monthly fee based on their purchases and/or income. This scheme is aimed at individuals who make sales of goods or services to final consumers. Individual limited liability companies can also benefit from the	A tax regime aimed at individuals and firms with some sector restrictions.	Applies to income attained from business activities, either by a formally established firm or an individual. In general, this income is the combination of labour income and labour.

	RUS.		
<b>Allowances to the tax base</b>	None	Cost of inputs to produce or maintain the source of income	Cost of inputs to produce or maintain the source of income Depreciation of equipment Research and innovation investments
<b>Tax rates or tax liability</b>	Tax liability varies according to the level of income: up to an income of PEN 60 000, tax liability is PEN 240; up to PEN 96 000, tax liability is PEN 600; up to PEN 156 000, tax liability is PEN 2 400; up to PEN 240 000, tax liability is	1.5% of net income	28% of net income

	PEN 4 800; up to PEN 360 000, tax liability is PEN 7 200  Includes access to the Entrepreneur SIS (healthcare system)		
<b>Annual thresholds</b>	PEN 360 000 per year	PEN 525 000 per year	
<b>Other implied costs</b>	Does not allow for tax credits due to value-added tax (VAT) and does not require bookkeeping		Requires bookkeeping consistent with international financial reporting standards

*Figure 16 Tax Regimes for individuals with businesses in Peru*

Source: OECD based on SUNAT (2016), Estadísticas y Estudios (Statistics and Studies) (database), La Superintendencia Nacional de Aduanas y de Administración Tributaria, Lima, [www.sunat.gob.pe/estadisticasestudios/index.html](http://www.sunat.gob.pe/estadisticasestudios/index.html)

The overlap of regimes can create perverse incentives. RER users can utilize invoices to subtract intermediate inputs and recover the VAT, whereas RUS users cannot. This converts VAT into a de facto cost, reducing efficiency for enterprises participating in this arrangement. Furthermore, given the duplication and tax benefits of various schemes, enterprises (single proprietor or larger) may choose horizontal disaggregation (i.e., some firms split into two or more pieces when they reach the maximum size to continue under the most favourable tax regime), resulting in tax dwarfism (Inter-American Development Bank [IDB], 2013). There is lots of anecdotal evidence to support this argument; but, finding the supporting evidence is more difficult,

given the high pace at which SMEs appear and disappear, as well as the volatility of their prices.

The reduction of formalization expenses for SMEs may have increased the number of registered taxpayers, but the special regimes have not resulted in considerable tax revenues. The number of registered taxpayers has expanded dramatically over the previous decade, particularly among RUS and RER customers. This was especially true for RER following the fiscal reform of 2007 (Decree No. 968), which raised the threshold for access and removed impediments to registration. Despite a rise in taxpayer numbers, tax revenue collection as a percentage of GDP from these programme remained small.

Despite these specific tax regimes, informality among SMEs remains persistently prevalent. One reason why SME legislation (particularly the SME Law passed in 2007) has not been more effective in eliminating informality and fostering compliance is because certain of its aspects, such as the social protection regime for SMEs' workers, have not been implemented. Furthermore, some of the benefits (such as the SIS-provided general health insurance) were already available without incurring the expenditures of formalization.

### **Policy recommendations To promote formal economic activities and employment and mitigate the impacts of informality in Peru**

- Reduce the pervasiveness of informality in jobs and labour conditions.
- Move towards universal basic health coverage: Implement a universal basic health care package that is either free or paid for, based on existing income tests and supplemented by contributory coverage.
- Extend Pension Coverage: Consider expanding the beneficiary set of non-contributory pensions (Pension 65); work toward universal coverage by first enlarging the beneficiary set of Pension 65.

- Improve working conditions: Increase the labour inspectorate's competence to solve issues of workplace safety for informal employees and businesses by providing information; follow their formalization. Provide financial education and encourage the development of savings and insurance products for vulnerable communities.
- Promote the formalization of jobs.
- Improve inspection and supervision systems.
- Reduce the costs of formal hiring, increase the benefits of being formal (monetary and/or services), and make it easier (more flexible), particularly for groups where these Create a well-defined method for determining minimum wages to limit existing discretion, while also tying its future evolution to productivity and price levels.
- Investigate the idea that this process includes the option of having distinct minimum wage evolution across regions.
- Subsidize low- and low-middle-income workers' social contributions.
- Contributions in addition to immediate benefits (e.g. insurance).
- Provide alternatives for including independent workers into the pension system, which should be mandatory again but accompanied by 1) greater information and options for progressive inclusion into the system and 2) allowances for individual contribution patterns (e.g. less regular contributions) are binding.
- Improve communication and financial awareness by emphasizing the advantages of formal work.
- Encourage company formalization by offering incentives and lowering the costs of formalization.
- Reduce the incentives for not formalizing (and to remain small, which encourages firm informality).
  - Reduce the costs of formalization while increasing the incentives for it.
  - Reduce the administrative and recurring expenditures associated with official status.

- Facilitate the transition to formality by reducing (or discounting) the expenses involved with the formalization of workers' historical benefits, which could be fully or partially subsidized.
- Make formal job creation and formal work opportunities a reality.
- Increase labour productivity by upgrading and using more relevant skills.
- Promote labour market institutions to improve labour market matching and raise the vitality of the Peruvian labour market.
- Link formal job creation efforts to larger productivity diversification and skills programs.

## **The Mandate for Policy Makers**

Governments are not sufficiently aware of the significant economic and social benefits of eliminating informality, and they do not devote sufficient resources to the effective implementation of tax and other legislation. Well-meaning policymakers may argue that informal businesses deserve a reprieve. In some ways, that is right, because imposing a substantial tax and regulatory burden on them would be unfeasible and socially destructive. Even when corruption exists, an official societal rationale for their survival is always offered: preventing unemployment among people stranded in outmoded industrial plants with nowhere to go. Closer examination reveals, however, that in these circumstances, it would be healthier for the economy and less expensive for the government to reward laid-off workers with cash benefits as well as relocation and retraining programs.

The traditional justifications demonstrate that governments undervalue what they can and must do to address all of the drivers of informality: high taxes, complex tax systems and rules, lax enforcement, and societal norms. Simply collecting taxes from more businesses may allow a government to reduce tax rates without diminishing tax income. Informality can be addressed one industry at a time to improve the odds of success and avoid abrupt and huge changes in employment. Indeed, no emerging market has ever succeeded in simultaneously tightening enforcement of all legal responsibilities across all sectors. The greatest benefits come from eliminating informality in situations when

informal players compete directly with formal ones and have a significant unearned cost advantage, or where enhanced enforcement has a knock-on effect on the remainder of the supply chain. In many nations, collecting retail value-added taxes is a smart place to start because it allows the government to learn about the revenues of the companies that supply the retailers and so increases enforcement among suppliers.

### **Strengthen Enforcement**

Many governments in developing countries wrongly believe that by forgiving past tax debts of enterprises that come forward, they might lessen the level of informality. Emerging-market governments should not only stop forgiving tax evasion, but also enhance the penalties for engaging in it. In developed countries, the penalty is normally two to three times the amount of the evaded taxes, plus imprisonment if the evasion is chronic or involves more than a certain amount.

Another approach for governments to improve enforcement is for them to collaborate with payment providers like banks and credit card firms to enhance the number of monetary transactions accurately documented by the collections system and hence the quality of data accessible to tax enforcers. Unfortunately, some governments take the opposite strategy, levying extra taxes that discourage people from using debit or credit cards. Instead, these governments should encourage their usage, as the data they provide could increase the collection of value-added taxes.

### **Eliminate Red Tape**

Streamlining the regulatory burden and removing red tape promotes enforcement as well. In many countries, for example, registering a new business is a time-consuming process. Countries with low registration rates must prioritize streamlining and enforcing new business registration laws. Local governments can be empowered to help. Moreover, simplifying the tax code can also make it easier to enforce.

## **Cut Taxes**

Finally, governments in emerging markets should explore lowering and spreading the tax burden in order to slow the growth of informality. Many emerging nations have big state sectors and generous social programs that are comparable to those seen in developed countries. High debt payments, strong armed forces, and large bureaucracies account for a considerable amount of government spending in many emerging countries. Expecting underdeveloped countries to drastically reduce their government spending may be unreasonable, if not unfair. Nonetheless, high taxes burden formal firms and are associated with high levels of informality.

Expecting underdeveloped countries to drastically reduce their government spending may be unreasonable, if not unfair. Nonetheless, high taxes burden formal firms and are associated with high levels of informality. Raising revenue from currently unregistered businesses can assist governments in lowering tax rates. Another way to reduce the tax burden is to redistribute some of it to personal income and property taxes.

## **6. Conclusion**

We are now able to paint a more thorough and in-depth picture of a phenomenon that has, for a long time, gone unnoticed, underappreciated, and neglected thanks to advancements made in the definitions and measurement of the informal economy over the past four decades. Seventy percent of the labour force in South and Southeast Asia, sixty-six percent in Sub-Saharan Africa (with the majority of these jobs in the informal sector in these two regions), and fifty-eight percent in Latin America, not including agricultural jobs, rely on the informal economy to make a living or run small businesses. Even though such a large portion may lead to low productivity and income, these activities still contribute significantly to GDP. In Latin America, the informal sector accounts for almost one-third of non-agricultural GDP when agriculture is included, and half, 46%, and one-fourth when agriculture is excluded.

The pervasiveness of the informal economy in Peru necessitates immediate action to prevent the negative impacts on Peru's economic future. Reduced GDP growth, lost tax

income, and lower national productivity can all stymie a rising economy. Myths persist, preventing Peru from addressing the informal sector. However, reducing its size would nearly always remove barriers to growth and development and provide significant economic gains. Reducing the level of informality is a difficult task with significant hazards. Peru's Government, on the other hand, can combat the problem and decrease the risk of additional social upheaval by tackling the core causes of informality—weak enforcement, the high cost of operating formally, and harmful societal norms.

Peru must address its informal economy through comprehensive social and labour reforms that minimize impediments to formalization while also incentivising workers to engage formally. Peru will not only increase its economy, but it will also reduce income inequality, amass human capital, and enhance the lives of millions of its residents. Self-employed street vendors spotted on Lima's streets will be able to simply register their firms, obtain easier access to cash, and expand their businesses. The owner of the community mini-mart in Lima's shantytown will finally be able to provide decent housing, healthcare, and education for her children. To better the lives of millions of inhabitants, Peru must integrate its people into the formal labour market, thereby investing in the country's economic future success.

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## Abbreviations

GDP	Gross Domestic Product
PPP	Purchasing Power Parity
ILO	International Labor Organization
SMEs	Small and Medium size Enterprises
IMF	International Monetary Fund
LFS	Labour Force Survey
OECD	Organization for Economic Co-Operation and Development
CEPLAN	Centro Nacional De Planeamiento Estratégico
SDGs	Sustainable Development Goals
INEI	Instituto Nacional de Estadística e Informática
PISA	Programme for International Student Assessment
R&D	Research and Development
CEIC	Circular Economy Innovation Community
VAT	Value Added Tax
MGI	Meghna Group of Industries
GMM	Generalized Method Of Moment
MIMIC	Multiple Indicator-Multiple Cause Method
SUNAT	SUNAT. Superintendencia Nacional de Administración Tributaria (National Superintendency of Tax Administration; Peru)
MSEs	Micro and Small Enterprises

FORLAC	Formalization in Latin America And the Caribbean
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