The **hidden dangers** of the informal economy

Governments suppose that the gray market creates jobs and relieves social tensions. Academics think it will disappear of its own accord. Neither idea stands up to scrutiny.

Diana Farrell

It's no secret that some companies operate partially or wholly outside the law by underreporting employment, avoiding taxes, ignoring product quality and safety regulations, infringing copyrights, and even failing to register as legal entities. The problem is particularly acute in developing countries, but it is widespread in some developed nations too (see "Making Portugal competitive," in the current issue). The World Bank estimates that this informal economy[1] generates 40 percent of the GNP of low-income nations and 17 percent of the GNP of high-income ones.[2] In some industries, such as retailing and construction, informality can account for as much as 80 percent of employment.

Policy makers show surprisingly little concern about this phenomenon. In emerging markets, governments frequently view it as a social issue and fail to understand its damaging effect on productivity and economic growth. The informal economy, they believe, creates jobs for unskilled workers and relieves urban employment tensions. Some academics argue that the informal economy will disappear over time as the formal manufacturing and service sectors grow and create more jobs. Well-meaning development experts believe that informal companies themselves will grow and

[1] The informal economy, sometimes called the gray market, refers to companies that are engaged in legitimate business activities but don't fully comply with tax and regulatory obligations—not to outright criminal enterprises, such as drug cartels, mafias, prostitution rings, and illegal gambling operations.

[2] Friedrich Schneider, "Size and Measurement of the Informal Economy in 110 Countries around the World," a July 2002 working paper (available at www.worldbank.org).

eventually join the formal economy if they are given credit and other types of technical assistance—hence the popular "microcredit" programs of recent years.

Research by the McKinsey Global Institute (MGI) has found these beliefs to be untrue. Rather than getting smaller, the informal economy is growing in many countries. Over the past ten years, MGI has studied informality within a variety of industries in a range of different countries, including Brazil, India, Poland, Portugal, Russia, and Turkey. MGI found that the substantial cost advantage that informal companies gain by avoiding taxes and regulations more than offsets their low productivity and small scale. Competition is therefore distorted because inefficient informal players stay in business and prevent more productive, formal companies from gaining market share. Any short-term employment benefits of informality are thus greatly outweighed by its long-term negative impact on economic growth and job creation.

Operating in the gray

Informality is among the most seriously misunderstood of all economic issues. Informal companies evade fiscal and regulatory obligations, including value-added taxes, income taxes, labor market obligations (such as social-security taxes and minimum-wage requirements), and product market regulations (including quality standards, copyrights, and intellectual-property laws). Evasion varies by sector and by the nature of the business: informal retailers tend to avoid paying value-added taxes, informal food processors to ignore product quality and health regulations, and informal construction firms to underreport the number of employees and hours worked.

EXHIBIT 1

More widespread than you would think

	Informal companies	
	Registered	Unregistered
Modern companies use state-of-the-art business practices and have productivity levels 2–3 times higher than traditional companies	Russian steel manufacturer **Unfair advantage:** *Free electricity* Indian software company **Unfair advantage:** *Copyright infringement*	Brazilian midsize supermarket chain, Chinese auto parts supplier **Unfair advantage:** *Tax avoidance*
Traditional companies use business processes and technologies that are several generations behind state-of-the-art practices	Turkish dairy processor **Unfair advantage:** *Partial avoidance of value-added tax (VAT), income tax, social-security obligations, hygiene standards*	Polish street vendor, Portuguese residential builder **Unfair advantage:** *Tax avoidance, use of informal suppliers*

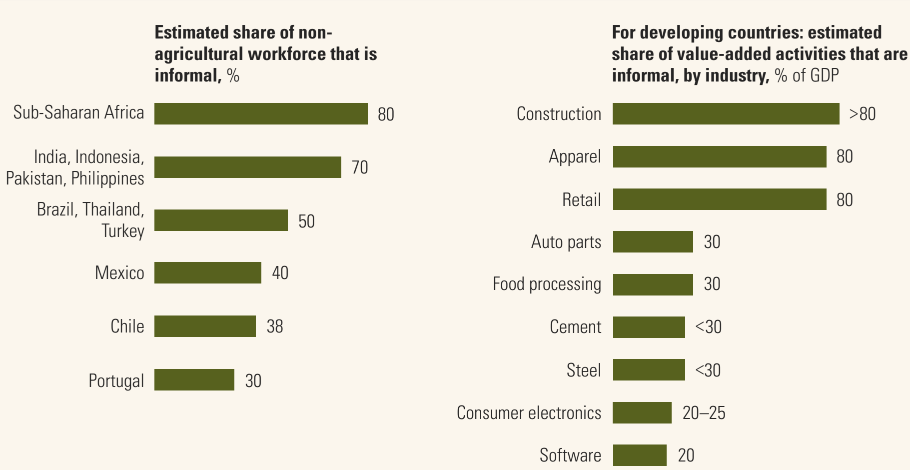
For many people, the informal economy means street vendors and tiny businesses, and it is true that informality is pervasive among small, traditional concerns with low levels of technology, scale, and standardization. But it is hardly unknown among larger, modern enterprises in developing countries (Exhibit 1), where MGI has found informal supermarket chains, auto parts suppliers, consumer electronics assemblers, and even large-scale industrial operations.

The extent of informality varies from industry to industry. It is greatest in service businesses such as retailing and construction (Exhibit 2), in which companies are often small in scale and geographically dispersed, making it easier to avoid detection. Revenues come from individual consumers and are difficult for auditors to verify. Labor costs are a significant share of total expenses, so companies are tempted to underreport employment. In one country, MGI found that construction workers ran away from sites when government inspectors appeared.

For similar reasons, informality in manufacturing industries is more prevalent in labor-intensive sectors such as apparel and food processing than in capital-intensive ones such as automotive assembly, cement, oil, steel, and telecommunications. Even so, some very large industrial and manufacturing companies operate informally. In India and Russia, for instance, local governments force local power companies to provide free energy to some businesses; subsidies such as these allow informal businesses to continue operating.

EXHIBIT 2

Shades of gray



Source: International Labour Organization; World Bank; McKinsey analysis

Three factors contribute to informality. The most obvious is limited enforcement of legal obligations—a result of poorly staffed and organized government enforcement agencies, weak penalties for noncompliance, and ineffective judicial systems. A second factor is the cost of operating formally: red tape, high tax burdens, and costly product quality and worker-safety regulations all prompt businesses to operate in the gray market. Finally, social norms contribute to the problem. In many developing countries, there is little social pressure to comply with the law. In some, many people see evading taxes and regulations as a legitimate way for small businesses to counteract the advantages of large, modern players.

Thus the informal economy is actually growing larger in many places. In Sweden, for instance, it is reported to be on the rise as some companies seek to avoid high taxes and restrictive employment laws. In Brazil, it now employs 50 percent of nonagricultural workers, up from 40 percent a decade ago. Its growth in many emerging markets stems from higher tax burdens and cuts in government enforcement budgets—sometimes the result of fiscal-austerity measures demanded by the International Monetary Fund and other international lenders.

Informality's deleterious effects

Informality stifles economic growth and productivity in two ways. First, the powerful incentives and dynamics that tie companies to the gray economy keep them subscale and unproductive. Second, the cost advantages of avoiding taxes and regulations help informal companies take market share from bigger, more productive formal competitors. Moreover, the adverse consequences of informality aren't solely economic; they are social as well.

The low-productivity trap

Academics, development experts, and government officials often assert that informality will lessen as time goes by and the formal sector grows. MGI research, however, indicates that informal companies become trapped in a self-reinforcing dynamic that confines them to subscale, inefficient, low-productivity work. Around the world, this research shows, they operate at just half the average productivity level of formal companies in the same sectors and at a small fraction of the productivity of the best companies.

Once a business decides to operate informally, its ability to invest in improving its operations and to finance growth declines. Since many informal companies aren't legal entities, they rarely borrow from formal credit institutions and instead rely on illegal moneylenders that charge exorbitant rates and advance only small amounts. Informal businesses can't rely on the legal system to enforce their contracts, protect property rights, or resolve disputes, so it is risky for them to engage in transactions with parties outside the immediate community. And operating informally creates perverse disincentives for growth, since a larger company might attract more government scrutiny.

Furthermore, informal companies tend to structure their supplier and customer relationships in ways that make it difficult to go aboveboard later; informal retailers, for instance, frequently buy goods from informal producers. Sometimes informal businesses form voluntary associations to enforce contracts and provide financing to members, thereby further deepening the roots of the gray economy. In many countries and industries—for example, the production and distribution of apparel in India, soft drinks in Brazil, and groceries in Russia—entire informal value chains have an almost insurmountable cost advantage over their formal counterparts. In addition, customers of an informal business come to expect very low prices, and many would go elsewhere if it transformed itself into a formal company and had to raise them.

The idea that informal businesses might grow and join the formal economy is therefore a myth. On the contrary, they shun opportunities to modernize and remain trapped in low-productivity operations. There is no better example of this problem than the efforts in the late 1990s of Migros Turk, Turkey's largest grocery retailer, to organize informal grocers under an umbrella brand that would have given them greater purchasing power and operational support. Few joined, for despite the benefits, the plan required them to comply fully with tax and social-security requirements.

Informal players thus persistently drag down a country's overall productivity and standard of living. In Portugal and Turkey, for instance, informality accounts for nearly 50 percent of the overall productivity gap with the United States.

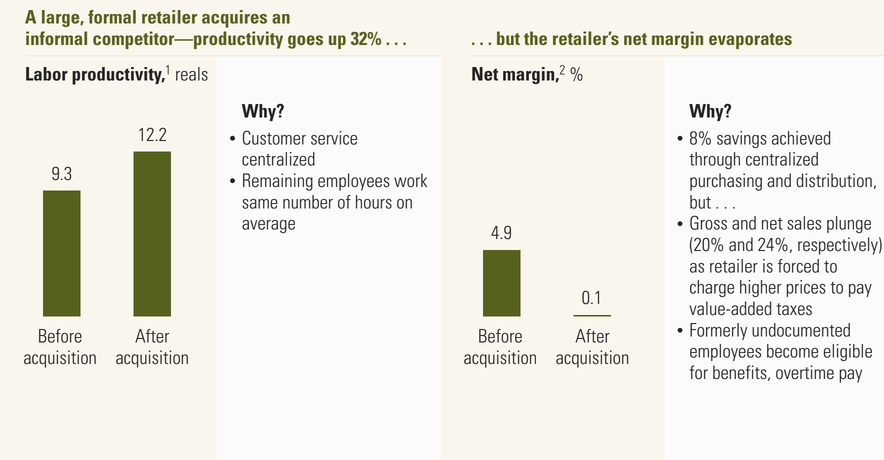
Curbing legitimate companies

Informality also stifles economic growth by preventing larger, more productive formal companies from gaining market share. The cost benefit of avoiding taxes and regulations often amounts to more than 10 percent of the final price. That advantage leaves informal businesses—despite their

EXHIBIT 3

Unintended consequences

Disguised example of Brazilian retailer



[1] Gross margin per employee-hour, in reals (Brazil's currency); figures are rounded.
[2] Based on net sales.

Source: Interviews; Associação Brasileira de Supermercados (ABRAS); McKinsey analysis

low productivity—free to undercut their formal competitors and to disrupt the normal competitive process, in which more productive companies capture market share and replace less productive ones.

Across the developing world, formal companies are at a disadvantage. In Russia, informal food retailers gain an estimated 13 percent price advantage over supermarkets by underpaying taxes and buying goods from informal suppliers. MGI found that if these retailers complied with their legal obligations, they would be at a 5 percent price disadvantage to modern supermarkets. Informality thus prevents supermarkets from gaining market share and discourages global retailers from making investments and bringing in new technology and best-practice operating methods.

In Brazil, formal supermarkets have found that they can't profitably acquire informal players, because of the unearned cost advantage. Although supermarkets could increase the productivity of the acquired businesses, their small scale drives net margins to zero once tax obligations are paid (Exhibit 3). Dairy processors in Turkey enjoy informality-related cost savings of almost 20 percent, so these companies survive despite their low productivity. Informal software companies in India appropriate innovations and copyrights without paying for them, reducing the revenues of formal companies. If software piracy rates fell to US levels, the industry's productivity and profitability would soar by nearly 90 percent.

Pervasive informality also slows economic growth by substantially reducing the tax receipts of governments, which must therefore raise the tax rates imposed on formal businesses. In addition to exaggerating the unearned cost advantage of informal ones, higher rates reduce the after-tax earnings that formal companies can invest in productivity-enhancing methods and technologies. A vicious cycle may emerge: higher taxes prompt enterprises to operate informally, raising the tax burden on the remaining formal companies, which already pay more than 80 percent of the taxes in most developing nations. This dynamic explains in part why the informal economy is growing in Brazil, notwithstanding a decade of economic liberalization and reform.

The social cost

Society pays too. Most developing countries, considering their stage of economic maturity, have generous social-security plans and labor rules for workers. The problem is that these provisions apply to only a fraction of them: people employed by the public sector and formal companies. The vulnerable workers of the informal economy earn, on average, lower wages, receive poorer health and safety protection, and have less opportunity to unionize.

Moreover, consumers have less choice. In developing countries, they can typically buy either very expensive, high-quality goods and services like those found in rich countries or cheap, low-quality goods and services from informal enterprises—often, without full knowledge of the hazards and risks. Goods and services targeted at the middle market are missing. Consumers may, for example, have a choice only between supersafe pasteurized milk or raw milk, luxurious dwellings or shanties, expensive modern shopping malls or tiny mom-and-pop shops, expensive Western cars or motorcycles and bicycles. The small and midsize businesses that might develop products to meet the needs of middle-market consumers are mostly informal, lacking the ability and incentives to fill the gap.

The mandate for policy makers

Conventional wisdom has it that informality stems from corruption and a lack of government resources, but the experience of MGI suggests otherwise: it has found that governments are insufficiently aware of the huge positive economic and social gains from reducing informality and don't devote enough resources for adequate enforcement of tax and other regulations.

Well-intentioned policy makers may argue that informal companies deserve a break. In a sense that is correct, since it would be impossible and socially damaging to impose a heavy tax and regulatory burden on them. Even when corruption is present, an official social excuse is always offered for their survival: preventing unemployment among workers trapped in obsolete industrial plants with nowhere to go. But closer analysis reveals that in these cases it would be better for the economy and cheaper for the government to compensate laid-off workers with cash benefits and with relocation and retraining packages.

The usual excuses show that governments underestimate what they can and must do to correct all of the sources of informality: high taxes, complex tax systems and regulations, weak enforcement, and social norms. Merely collecting taxes from more companies could well enable a government to cut tax rates without reducing its tax revenue. In Turkey, for instance, MGI found that the state collects just 64 percent of the value-added-tax (VAT) revenue it is owed on retail sales. If it increased enforcement and collected 90 percent, the VAT rate could be lowered to 13 percent (from 18 percent) without decreasing government revenues.

To improve the chances of success and to avoid sudden and massive changes in employment, informality can be addressed one sector at a time. Indeed, no emerging market has ever successfully tightened enforcement of all legal obligations for all sectors simultaneously. The biggest gains come from reducing informality in those where informal players compete directly with formal ones and have a large unearned cost advantage or where increased enforcement has a ripple effect on the rest of the supply chain. In many countries, the collection of retail value-added taxes is a good place to start, since it enables the government to gain information about the revenues of the companies that supply the retailers and therefore improves enforcement among suppliers as well.

Strengthen enforcement

In most countries, the informal economy thrives because of weak enforcement, not regulatory loopholes. The first step, therefore, is to add resources and beef up a government's audit capabilities. Developed countries typically have far more people to collect and enforce taxes than developing ones have (Exhibit 4). In addition, developed countries separate tax processing from auditing, and many set up distinct audit units specializing in tax fraud at particular types of companies; Austria and the United Kingdom, for instance, have specialist auditors for large businesses. Many developing countries lack even a separate audit department. And developed countries use sophisticated methods (based, for example, on past reported revenues or on the records of suppliers) to choose companies for audits, but governments in emerging markets investigate companies at random or in reaction to complaints. Ineffective court systems exacerbate the problem by making it difficult to prosecute tax evaders even when they can be identified.

Paradoxically, tax enforcement is also hampered by frequent tax amnesties. Many governments in emerging markets mistakenly believe that they can reduce the level of informality by forgiving past tax debts of companies that come forward. Turkey, for instance, has had ten tax amnesties since 1963—one nearly every four years—and five social-security amnesties since 1983. Their provisions included the right to base the payment of past taxes on historical values of Turkey's currency, the lira. Given the country's high inflation rates, this approach greatly reduces the amount businesses have to pay. Governments forgo significant revenues from such amnesties and, even worse, make ongoing enforcement more difficult, since companies wait for the next amnesty before coming clean.

Governments in emerging markets should not only stop forgiving tax evasion but also increase the penalties for engaging in it. In developed countries, the penalties are usually two to three times the amount of the evaded taxes, coupled with imprisonment if the evasion is persistent or involves more than a set amount. Tax evaders in emerging markets often get by with a slap on the wrist; in Turkey, for instance, the fine for VAT evasion is less than $20.

EXHIBIT 4

Whatever the penalties, enforcement matters

	Tax employees per 1,000 of population	Selected fines and penalties
United Kingdom	1.6	Unreported VAT fined at either statutory maximum or 3 times amount of tax evaded and/or up to 6 months in prison; graduated 2–15% fines for late payment
France	1.3	Late payment of income tax fined at 0.75% per month; 40–80% additional charge for late submission of income statement
Poland	1.3	Unreported VAT fined at 30% of total, unreported income at 75%
Portugal	0.2	Efforts under way to stem VAT evasion; tax revenue from self-employed/small businesses low, enforcement difficult
Turkey	0.03	Late payment of income tax fined at 5% per month; negligible fines for VAT evasion (<$20); overall tax evasion rate is as high as 225%[1]
India	0.006	Late payment of income tax fined at 24% per year; concealment/underinvoicing of goods fined at 50% of value
Brazil	0.004	Late payment of income tax fined at 0.33% daily up to maximum of 20% of total; reduction of 50% if paid before final day of appeal period

[1] For every 1 unit of tax collected, 2.25 units are evaded.

Source: Economist Intelligence Unit; Organisation for Economic Co-operation and Development (OECD); tax authorities of countries shown; McKinsey analysis

Another way of improving enforcement is for governments to partner with payments providers such as banks and credit card companies to increase the number of monetary transactions accurately recorded by the collections system and thus to raise the quality of the data available to tax enforcers. Unfortunately, some governments in effect take the opposite approach by levying incremental taxes that discourage the use of debit or credit cards. These governments should instead encourage their use, since the information they provide could improve the collection of value-added taxes.

Eliminate red tape

Streamlining the regulatory burden and reducing red tape also promote enforcement. Registering a new business, for example, is an onerous process in many countries; Hernando de Soto, the noted economist and author, reports that it takes an average of 549 days to register a new bakery in Egypt.[3] When businesses fail to register as legal entities, collecting taxes and enforcing regulations become difficult, if not impossible. Countries with low registration rates must therefore make streamlining and enforcing the rules for registering new businesses a priority. Empowering local governments can help. In Turkey, most businesses—even informal ones—register, mainly because the municipal authorities, starved of resources, are vigilant about collecting the fees. This is a good first step that will make it far easier for the country to improve enforcement.

Simplifying the tax code can also make it easier to enforce. Spain's innovative code for small and midsize businesses varies by sector and relies on their physical characteristics rather than their reported revenue, which is difficult to verify. (Food retailers, for instance, can choose to have their taxes levied on the size of the sales floor.) This option has proved popular, and as a result the government has increased the amount of taxes collected from small and midsize businesses by more than 75 percent.

Cut taxes

Finally, governments in emerging markets must consider reducing and redistributing the tax burden to help slow the growth of informality. Many developing countries have large state sectors and generous social programs similar to those in rich countries. Brazil's government, for instance, spends well over 30 percent of the country's GDP—slightly more than its US counterpart. What's more, in 1913, when the United States had the same per capita income that Brazil has today, the US government spent just 7 percent of the country's GDP. In many developing countries, high debt payments, large military forces, and sizable bureaucracies account for a significant portion of government expenditures.

---

[3] Unpublished working paper, 2003.

It may be unrealistic, and even unfair, to expect developing countries to reduce their government spending dramatically. Still, high taxes encumber formal enterprises and are correlated with high levels of informality. Nowhere is this point better illustrated than in the food-retailing industries in Brazil and Mexico. Informal food retailers have captured nearly 80 percent of the market in Brazil, where VAT on food averages 12 percent; social-security and income taxes add to the burden. The biggest contributors to the phenomenon of informality are the modern grocery chains, which now command more than 60 percent of the market. In Mexico, by contrast, most food is exempt from VAT. Informality is unknown among modern retailers, and even a substantial number of small, traditional urban retailers register and pay taxes. (Mexico does, however, levy a high VAT on tobacco and alcohol sales, and these sectors consequently suffer from much higher levels of informality.)

Raising collections from currently informal enterprises can help governments cut tax rates. Another way of reducing the tax burden is to redistribute it by shifting some of the burden to personal-income and property taxes. In Brazil, as in other emerging markets, more than 80 percent of all tax revenues are collected from businesses, compared with half that level in developed countries. Raising property and personal-income taxes would not only make it possible to reduce corporate-tax rates but also, perhaps, improve enforcement, since property taxes are typically collected by local governments. Their local roots make it easier for them to ferret out tax evaders, and their limited tax resources give them a strong incentive to do so.

Persistent myths keep developing countries from addressing the informal sector. Yet diminishing its size would, in almost every case, remove barriers to growth and development and generate sizable economic gains. Reducing the level of informality is no easy task and carries risks that are not inconsiderable. But by addressing the root causes of informality—weak enforcement, the high cost of operating formally, and injurious social norms—governments can attack the problem and reduce the possibility of further social disruption. Q

The author wishes to acknowledge the colleagues around the world who contributed to the McKinsey Global Institute's deep understanding of informality and to the development of this article in one form or another: Didem Dincer Baser, Heinz-Peter Elstrodt, Bill Lewis, David Meen, Vincent Palmade, and Jaana Remes. The perspectives put forth here synthesize a range of past MGI reports, including those on Brazil, India, Poland, Russia, and Turkey, which were developed in close collaboration with each of the local McKinsey offices and with external academic advisers.

•

Diana Farrell is the director of the McKinsey Global Institute and a principal in the San Francisco office.