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THE INFORMAL ECONOMY IN PERU: A BLUEPRINT FOR SYSTEMIC REFORM

Korey Finn

Introduction

A drive through the streets of Lima provides a vibrant picture of the informal economy in Peru. As you make your way through the city center, you witness countless self-employed street vendors pitching everything from hand-made alpaca sweaters to bags filled with leaves from the coca plant. Around you chaotically whiz micros (medium-sized buses) and combis (small vans) whose drivers are rarely registered with the city authorities and with whom Peruvians advise you ride "at your own risk." As you approach the city limits, the landscape reveals rolling hills with seemingly every inch covered in small 6-by-3–meter tin houses that characterize Lima's shantytowns. The Peruvians here are seldom able to travel into the city for income opportunities, finding whatever work they can within their neighborhoods to provide for themselves and their families. One woman described making a living by selling milk, bread, and other essentials in the neighborhood mini-mart, earning less than $2 a day. These Peruvians have one thing in common—they operate in the pervasive informal economy, which disproportionately affects Peruvian workers.

In the past two decades, Peru has experienced an economic boom which has yielded many economic benefits—lower rates of poverty, a reduction in unemployment, a stabilized currency, low inflation, and increased foreign investment. Peru nearly doubled the size of its economy from 2002 to 2012 and achieved among the highest GDP growth rates in the region (FORLAC). However, a majority of Peru's workforce—73 percent—remain in the informal economy (CEPLAN). Informal activity contributes 19 percent of Peru's GDP (CEPLAN). Under current conditions, Peru's informal sector will employ a significant portion of the nation's labor force—more than 30 percent—until at least 2050 (CEPLAN), and this will have a negative impact on economic growth.

The socioeconomic consequences of a large informal economy can be significant for a developing nation. On a macroeconomic level, high levels of informality are associated with high levels of poverty, income inequality, and social exclusion. From a labor standpoint, jobs within the informal sector are often subject to poor employment conditions. Because these jobs are unregulated, many workers lack protection against compulsory overtime, layoffs without notice or compensation, and unsafe working conditions. They are also ineligible for social benefits such as sick pay, health insurance, and pensions. There are 7.5 million Peruvians in the informal economy, and therefore 7.5 million individuals who do not make social contributions to the government, who are not covered by health insurance, and who do not receive a host of other public services or protection from the government.

While Peru has an impressive record for growth, economic growth alone is an insufficient condition for the formalization of employment. For Peru to significantly decrease the size of its informal economy, it is necessary to implement a cohesive package of integrated economic, social, and labor policies that complement sustainable economic growth.

Defining Peruvian Informality

The informal economy can be defined as all unregistered economic activities that contribute to GDP and generate unreported income through the production of legal goods and services. These include primarily private businesses and individuals who do not possess appropriate documentation and who consequently do not pay social contributions and do not receive social protection from the government.

Beneath the umbrella of the informal economy exist two distinct concepts: the informal sector and informal employment. The informal sector is *enterprise-based* and is defined as all people employed in at least one informal enterprise. It is measured as the percentage of GDP associated with production in these enterprises. Informal employment is *jobs-based*, referring to jobs and employed persons as individual units. It is measured as the percentage of the total labor force employed informally. To paint a complete picture of a country's informal economy, it is necessary to include both measures.

Furthermore, there are two types of participants in the informal economy: those who participate as a means of survival due to a lack of economic alternatives, or "survivalists," and those who participate due to a cost-benefit analysis relative to other employment options, "entrepreneurial" participants. Entrepreneurial participants choose informality as the more profitable short-term option.

Peru's informal economy predominantly consists of workers with less than a high school education, low-income workers, workers under 30 years old, women, and agricultural workers. Eight of ten women who work are employed informally. The informal economy employs 95 percent of workers with less than a high school education, 98.8 percent of low-income workers, and 97.2 percent of agricultural workers (CEPLAN). These groups are the most likely to be impoverished and, therefore, should be most targeted by social programs. The linkage of social benefits to formal employment means that the groups most in need of aid and services lack access to them.

Peru's rate of informality is among the highest in Latin America, surpassed only by Guatemala, Honduras, and El Salvador, all of which have significantly lower per capita GDPs. Peru's informal sector GDP of 19 percent is above that of neighbors Brazil and Chile (12.3 percent and 4.8 percent, respectively) as well as the Latin American average (13.5 percent) (CEPLAN).

Peru is also not reducing its informal employment faster than its neighbors. In 2007, 80 percent of the labor force was employed informally (Thorne); therefore, the current situation represents just a seven percentage point reduction over seven years. At this rate of improvement, the percentage of informal laborers in 2050 will remain higher than the average percentage in Latin America today.

In response to the socioeconomic obstacles related to informality, Peru's president, Pedro Pablo Kuczynski, announced his goal of doubling the percentage of the labor force employed formally to 60 percent. To achieve this, Peru must identify the primary drivers of informal activities and implement targeted legislation to reduce this portion of the economy.

Drivers of Informality

The informal economy is complex and heterogeneous, making it impossible to identify a universal definition of its root causes. In Peru the informal economy is propelled by a combination of drivers, some for survivalists and some for entrepreneurial participants.

Survivalist Participation

For the survivalist segment, the root of the challenge is the inability to accumulate human capital. The average number of years of education is negatively correlated with the size of the informal economy (Bohl et al.). Informal activities contribute 19 percent of Peru's GDP, whereas formal education for adults ages 15 and up averages 8.9 years. In comparison, Peru's neighbor Chile possesses a formal education average of 10.1 years and less than five percent of its GDP due to informal activities (CEPLAN). Peru also consistently ranks among the lowest scoring countries on international standardized tests, such as the Programme for International Student Assessment (PISA) test. Low test scores and low labor productivity are highly correlated (Thorne). Peru is ranked at the bottom with the lowest PISA math test scores and lowest labor productivity (Figure 1).

Improvements to the education sector are imperative to increase the productivity and earning power of citizens. Policies promoting investment in human capital, such as reducing the cost of education and providing financial security in mitigating external fiscal shocks to a household with limited funds set aside for education, aim to break the feedback loop of informality with poverty and low labor productivity. In the long run, the development of human capital, such as education, can also be a leverage point for societies to improve global competitiveness.

Entrepreneurial Participation

For entrepreneurial participants, drivers of informality include forces that act as barriers for participants to join 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).

Among the push factors are government regulation, taxation, and corruption. The most significant of these is government regulation. In Peru, business and labor are more highly regulated than in most countries of the developed world. Peru is ranked 133rd of 140 countries with respect to the flexibility of companies to hire and fire workers (Schwab). Peruvian workers are entitled to 30 days of vacation per year, two annual bonuses equal to one month's salary, health insurance, life insurance, and a stipend for those with children. Peruvian law forbids layoffs, and workers can only be fired for specified legal reasons. Workers deemed fired arbitrarily are entitled to up to one-and-a-half year's salary in severance (World Bank).

In 2016, Peru ranked 50th of 189 countries for its cost of doing business (World Bank). The ranking fell five places from 2015, an unfavorable trend. The same study ranked Peru 97th for ease of starting a business. This ranking considers such factors as the average number of procedures required as well as the median number of days necessary to register a firm, the fees associated with registration, and the minimum paid-in capital required of the prospective business owner. Registering a new firm takes an average of 26 days, compared with 8.3 days in Organisation for Economic Co-operation and Development (OECD) countries. It takes business owners more than three times as long to register firms in Peru as those in developed countries. Moreover, Peru's ranking fell seven places from 2015.

A team of economists conducted an experiment to illustrate the difficulties of starting a business in Peru. They set out to open a small garment shop in Lima's outskirts (de Soto, p. 18). The team completed the required paperwork, waited in queues, and made many bus trips into central Lima to get the necessary certifications. Dedicating six hours a day, the team finally registered the business 289 days later. This is not an uncommon situation for low-income Peruvians attempting to open small businesses. For those without the funds or the ability to navigate the bureaucratic red tape, operating without the proper documentation is an attractive alternative.

In addition to regulations, Peru's corporate taxation is an important push factor. According to Bohl and colleagues, the total share of taxed profits and mandatory contributions from a firm is positively correlated with the size of the informal sector. Put simply, higher tax rates yield larger informal economies. Firms overburdened by taxes and mandatory payments may evade them by staying informal, thus raising net earnings. Participants face a simple cost-benefit dilemma, made all the easier to address as the tax burden increases.

In the World Bank "Doing Business 2016" study, Peru ranked 50th in ease of paying taxes, where a lower ranking corresponds to a lower overall tax burden (which includes the taxes and other contributions a medium-sized firm must pay or withhold each year as well as the administrative burden of paying these taxes). Peru's total tax burden of 35.9 percent of profits is smaller than the 41.2 percent average in developed countries (World Bank). However, when factoring in the time to prepare, file, and pay all taxes and social contributions, Peruvian firms on average spend 260 hours per year compared to the 176.6-hour average in developed countries (World Bank). This difference is due to the complicated tax filing process, driven by complex legislative policies and strict government regulation. Moreover, according to research by Peru's Ministry of Labor, current tax regimes undermine business growth and reduce net profits by 12 percent to 50 percent and ultimately serve to raise the rate of tax evasion. Of Peru's value-added tax (VAT), 31 percent of the potential revenue is evaded, compared with 24 percent in Mexico, 23 percent in Colombia, 22 percent in Chile, and just 13 percent in Uruguay (Thorne).

The final constraint to formalization is government corruption. A high level of corruption is indicative of a higher tolerance among officials for unreported economic activity. Although measuring corruption is difficult, many analyses use public perceptions of corruptness as a gauge. The Transparency International "Corruption Perception Index 2016" assigns Peru a score of 35/100 in corruptness, with 100 indicating least corrupt. Peru placed 101st of 176 countries in perception of corruptness, whereas neighbors Chile and Uruguay placed 24th and 21st, respectively. Corruption is effectively an indirect tax that entrepreneurs pay to avoid regulatory burdens. In an environment with high corruption, an entrepreneur in a legitimate line of work may still feel the need to keep extra cash off the books to pay officials who demand bribes. Therefore, firms facing high levels of corruption tend to see the costs of formality outweighing the benefits.

Participants and firms must consider the potential benefits received by engaging with state rules. Pull factors, which are inversely related to the size of informal economies, include government spending on research and development, government transfers to households, and government effectiveness. Research and development expenditures strengthen firms and make them more competitive. Government transfers include social programs and safety nets, such as state pension funds and welfare. Linking these benefits to the formal economy provides strong incentives to operate in the formal sector. Evidence suggests that the effectiveness of government in dispersing these incentives is critical to whether the incentives pull people into the formal sector.

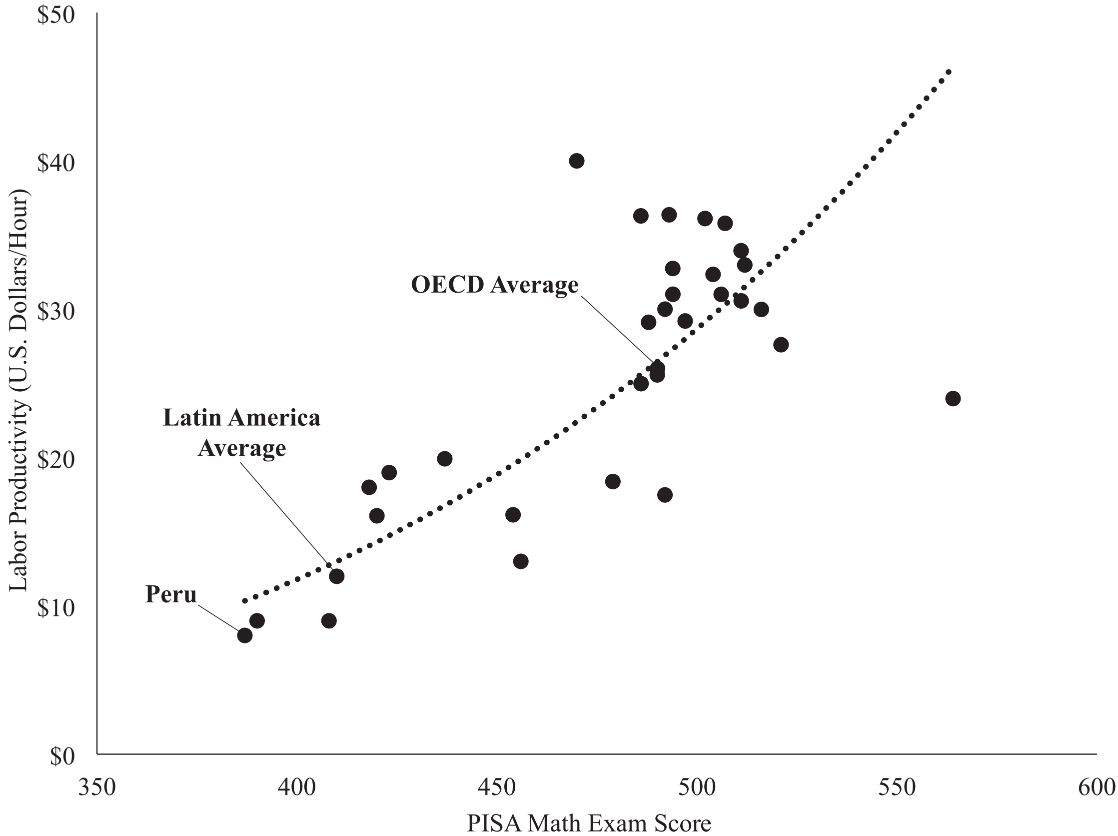
Tackling Informality with Legislative Reform

Institutional Change with Limited Success

The Peruvian government has attempted to mitigate the socioeconomic challenges caused by the informal sector through legislative policies. But these policies have achieved only limited success. As discussed previously, informal employment decreased by only seven percentage points from 2005 to 2012 (Thorne). And this reduction was achieved in the context of several positive external factors, notably a favorable economic cycle that expanded the job market.

One institutional change was the 2007 implementation of the e-payroll system. Businesses with three or more employees were

Figure 1
Labor Productivity vs. PISA Math Exam Scores



Source: Thorne.

mandated to report specific tax information to the nation's tax authority, SUNAT (FORLAC). The implementation of this system made it easier to monitor and enforce tax and labor obligations and contributed to the registration of 340,000 jobs, an estimated 276,000 of which are new formalized jobs (FORLAC).

Peru has also recognized the need for regulation to specifically encourage the formalization of micro and small enterprises (MSEs), because MSEs experience disproportionately high informality. Tax regimes were simplified for MSEs through the Single Simplified Regime, which allows small businesses to pay a monthly fixed sum in lieu of filing tax returns. These enterprises generally avoid paying income, sales, and municipal taxes (FORLAC). Additionally, the Special Income Tax Regime for MSEs permits the payment of the monthly sum based on net income at a rate considerably lower than the corporate rate of 30 percent (FORLAC). The goal of these programs is to decrease the tax burden on MSEs, thereby reducing a key barrier to formalization, as well as to ultimately expand the tax base. Despite these well-intended policies, there has not been a significant reduction in informality. In 2011, only five percent of MSEs in Peru were formally registered (FORLAC).

Shortcomings of Peru's Current Approach

In 2016, Peru's finance minister, Alfredo Thorne, presented an ambitious plan to reduce the informal economy, targeting a reduction to 30 percent of the labor force by

2021. Thorne's strategy involves three reform pillars: reduction of barriers to formalization, improvement of quality and access to public services, and creation of pro-formalization regulatory policy. Although the plan includes many sound, comprehensive policies, there are some crucial areas in which it falls short.

To address the reduction of barriers to formalization, Thorne identified tax and administrative simplification, higher-quality protection for workers, and improved credit access as important policy objectives. Tax simplification policies would propose new tax schemes to provide greater incentives for formalization. President Kuczynski announced in September 2016 his plan to reduce the national sales tax (VAT) from 18 percent to 17 percent (Post, "Peru Govt...") to attract informal businesses to register with the state. To offset the lost revenue, Kuczynski proposed raising Peru's corporate tax rate. However, although reducing the VAT may decrease barriers to registration, a corporate tax rate increase would have the opposite effect. An increase in the corporate tax rate may shrink the tax base, because more firms find it costlier to remain formal and therefore opt out of paying taxes altogether. In other countries, a reduction in the corporate tax rate has been shown to expand the tax base. Portugal reformed its tax structure in 2014 to decrease the corporate tax rate from 25 percent to 19 percent and reintroduced a simplified corporate tax reporting system for MSEs (Loureiro and Cunningham). This policy increased the overall tax base—of the €37 billion tax revenue in 2014, €754 million was associated with the anti-evasion program (Loureiro and Cunningham). And Portugal also became more attractive for doing business, rising from 51st to 36th from 2014 to 2015 (World Bank).

Many aspects of Thorne's plan attempt to incentivize workers to join the formal sector. In the framework of improved quality and access to public services, Thorne proposes expanding the coverage of health services and improving the quality of education to increase human capital.

The final pillar of Thorne's plan involves the implementation of pro-formalization regulatory policy. He proposes creating a National Council for Competitiveness and Formalization to identify changes in policy to encourage formalization. These reforms may include business training, strengthening of institutions, improvement in the rule of law, and greater access to credit. Many MSEs face a limited and expensive supply of credit, with interest rates usually between 20 percent and 33 percent. Providing greater access to lower cost funding will incentivize formalization.

Many of Thorne's policy approaches are similar to what other countries in the region have effectively adopted. However, Thorne's plan does not address loosening Peru's stringent labor regulations, a significant barrier to formalization. Lima Chamber of Commerce lawyer Victor Zavala summarized Peru's most urgent problem: "Today it is easier to close a business than to fire an employee" (Post, "Peru's Formalization…"). If Peru expects to significantly reduce its informal sector, the government must reduce labor regulations.

An Integrated Policy Approach

Many of the policies implemented over the past decade have failed to significantly tackle the problem of informality. This may be because the reforms were not cohesive but instead were designed to address disparate issues, which made for an ineffective overall impact. The solution, and what has proved successful for many other countries, is a heterogeneous approach to legislative reform. Peru must employ a package of integrated, comprehensive changes to achieve two goals: (1) decrease barriers to formalization for informal workers and enterprises and (2) provide appropriate incentives to attract individuals and firms to the formal sector. These two goals can be thought of as reducing the push factors and increasing the pull factors of formalization.

As discussed previously, a primary push factor is Peru's corporate tax policy. Many small firms lack the resources to prepare, file, and pay all taxes and mandatory government contributions. For this reason, many countries have benefitted from taxation reform for MSEs, which, by decreasing the amount they pay in government contributions, reduces the barrier to these enterprises to formalize. Such reforms have included measures to both reduce the tax burden for compliers and to encourage compliance. For Peru, the former objective can be achieved by reducing the corporate income tax, providing tax concessions in industries with a high percentage of informal workers, and introducing tax reductions for low-wage earners. To encourage compliance, policies should simplify the tax structure for SMEs and eliminate overlapping payroll taxes, making it easier to file and pay (Oviedo). The goal of this reform is to collect more of the lost government revenues due to tax evasion. This would increase government revenues, thereby decreasing fiscal borrowing, reducing budget deficits, and lowering inflation rates. Additionally, with the potential for consequently greater spending on public welfare programs, such tax reforms would help shrink income inequality (Wedderburn). For firms, compliance with tax policies could make it easier to obtain financing to grow their businesses. Because firms are required to maintain proper accounting records, they will be able to demonstrate collateral and the ability to repay debt, allowing them to obtain loans (Wedderburn).

Tax reform alone, however, is insufficient to reduce the number of informal firms; the tax administration must also address efficiency and enforcement issues. This is because a tax regime that is unequally enforced—for example, one that offers tax deductions to large corporations in exchange for political support—will continue to perpetuate income inequality and push smaller enterprises towards informality.

Peru's neighbor to the east offers an example of successful tax reform. In 1997 Brazil implemented the Integrated System of Taxes and Contributions for Micro and Small Enterprises, which replaced six types of federal taxes and five types of social security contributions with a progressive tax levied on gross revenues. This program linked social security contributions to a firm's revenue as opposed to the number of workers employed; consequently, it reduced the cost of hiring another worker, thus eliminating the incentive to employ informally (Oviedo). Because of this program, Brazil achieved a rise in the registration rate of firms of between 10 percent and 30 percent (de Paula and Scheinkman).

Legislative policies to decrease barriers to formal entry should also address onerous labor regulations. In 2015, the World Bank offered recommendations for Peru to increase its productivity and to sustain economic growth. Its report identified the informal economy as a key barrier to sustained growth and recommended that Peru, most importantly, should loosen labor regulations. World Bank official John Panzer summarized the main finding of the report: "[More flexibility for employers] will compel the informal sector to join the formal sector, because it allows greater access to credit, resources and support from the state" (Post, "World Bank..."). He also emphasizes that "the restrictive laws in regard to firing workers prevent employers from hiring new employees. As a result, this promotes informality and reduces productivity" (Post, "World Bank...").

Peru may find that the best place to start to lessen the burden of regulation would be to enable employers to hire and fire workers more easily. To create flexibility in hiring and firing, Peru could begin by eliminating policies that forbid layoffs and by broadening the definition of "just cause" for dismissal. It should, in particular, clear the way for firms to adjust their workforces during varying economic cycles and to encourage part-time and temporary contracts for unemployed workers (Oviedo).

Addressing tax policy and labor regulation will alleviate some of the costs of formalizing, but additional measures must be taken. One barrier to formalization is the difficulty with which a small business can register with the state. For de Soto's team of economists, a major barrier to registration was the lack of transportation between Lima's slums, where their business was located, and the city, where the registration centers were located. Peru could ease this burden by establishing registration offices in many central neighborhoods. The Ministry of Labor could also position officials in those areas to directly provide legalization assistance and facilitate the arduous process of registering with the state.

Many countries, including Mexico and Colombia, have expedited the formalization process by introducing a one-stop shop for business registration. In Mexico, the Fast-track Business Creation System guarantees that MSEs can complete the registration process in two days and has reduced the number of procedures from eight to two (Oviedo). Estimates are that this policy doubled the number of new firm registrations from four percent to eight percent (Kaplan et al.).

Additionally, the Peruvian government should consider providing regularization loans to small businesses as an incentive to formalize. Many MSEs struggle because of limited access to capital, and formalizing their business may eat into already limited profits. Offering expanded and cheaper credit to firms who can prove 100 percent formal workforce participation will allow these firms to access the capital that they desperately need to grow their businesses (Porembka).

Finally, strong social programs are often the carrot that incentivizes informal participants to opt into the government's rule of law. They also help redistribute income to the poorest members of society and thus reduce income inequality. Brazil experienced success with its Bolsa Familia program, which unified municipal, state, and federal government income programs and became the largest wealth-transfer and poverty-fighting program in the country (Domingues Junior). The program fought social inequality, while at the same time empowered families by enabling them to leave informal work conditions (Domingues Junior). Because of this and many other integrated policy reforms, such as the tax reform policy discussed previously, from 2002 to 2013 informal employment in Brazil decreased by 19 percentage points to 37 percent, while the informal economy fell from 40 percent of GDP in 2002 to just 12.3 percent (CEPLAN).

Peru can incentivize labor force participation by providing training to small-scale entrepreneurs on the technical skills needed for success. Peru could also address gender inequality in informal participation by providing gender-specific training for women. Sri Lanka was successful in implementing a similar strategy by initiating a training program that enabled informal workers to obtain technical skills through both private and public training institutions (Flodman Becker). Chile went even further, levying fines on informal sector business owners for noncompliance with training.

International experience suggests that when a government makes informality a top priority and tackles it with broad and integrated reform, significant advances can be quickly achieved. Spain offers a useful example of such comprehensive reform. It implemented a package of reforms aimed at reducing the costs of being formal, improving audit technology, and increasing enforcement to fight tax evasion. It modernized administrative processes and provided more extensive and efficient social protection (Oviedo). Among the reforms in this package were the simplification of the tariff system, the introduction of legislation allowing for temporary employment, and the reduction of social security contributions for part-time employees. Also included were social policies designed to de-link certain benefits from labor contracts, such as moving from a social insurance system financed by payroll taxes to a universal healthcare system financed by general taxation (Oviedo).

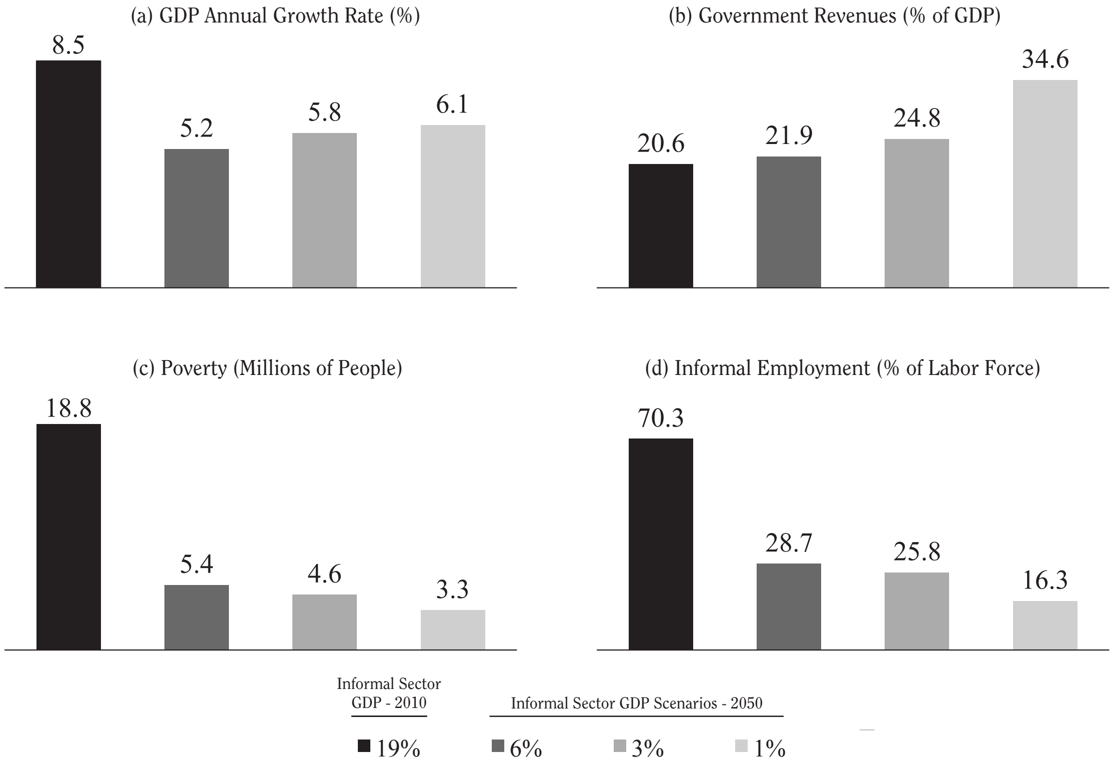
The Year 2050: An Economic Snapshot

If Peru does not reduce its informal economy, the informal sector could potentially be a major drag on the country's economic future. A study by CEPLAN[1] assessed the impact that the informal sector can have on such key economic variables as GDP, unemployment, and average income. The study explored several scenarios, including a most optimistic scenario in which Peru succeeds in reducing the size of its informal economy to one percent of GDP and a pessimistic scenario that continues current trends (CEPLAN).

The baseline scenario examined what would happen to the size of the informal economy if Peru continues to reduce its informal economy at the present rate. By the

[1]CEPLAN is Peru's National Center for Strategic Planning and seeks to improve the quality of life of the population and contribute to the sustainable development of the country.

Figure 2
Impact of Reducing Informal Sector GDP in 2050



Source: CEPLAN.

year 2030, informal activities would comprise 13.8 percent of GDP, which would still be higher than the current 13.5 percent Latin American average. By 2050, Peru would be among the region's top two countries with the highest informal sector, at six percent of GDP, with only Colombia coming in worse (CEPLAN). Informal employment in Peru would be about 50 percent in 2030 and 30 percent in 2050. Compared with current figures for countries, such as Mexico (54.3 percent), Argentina (49.7 percent), Brazil (42.2 percent), and Chile (32.3 percent), Peru's informal economy in 2050 would only be slightly smaller as a percentage of the workforce than that in Chile today. Additionally, it would still have the highest rate of workforce informality in the region (CEPLAN).

The CEPLAN study quantified various scenarios to examine the impact that a reduction in the informal sector would have on overall GDP growth, government revenues, poverty, and informal employment. Figure 2 illustrates the change in these four variables by 2050 in three cases: if informal GDP stands at the predicted six percent; if it is reduced to three percent; and the most optimistic case in which it is reduced to one percent. In each reduction case, there is a positive impact on all four major economic variables. GDP growth is increased by almost a full percentage point, government revenue is increased by 13 percent, poverty is reduced by more than 2 million people, and informal employment is reduced by 12 percent (CEPLAN).

A persistent and sizeable informal economy in 2050 is not desirable for Peru's continued economic growth. If left unaddressed, it will restrict economic development, shrink government revenues leading to higher deficits and less funding for social programs, and leave millions of people unemployed and millions more employed but in poverty.

Conclusion

The pervasiveness of the informal economy in Peru requires immediate action to mitigate the harmful effects it will have on Peru's economic future. Reduction in GDP growth, loss of tax revenue, and reduced national productivity can severely impede a growing nation. Peru must address its informal economy with integrated social and labor reforms, to both reduce barriers to formalization and incentivize workers to participate formally. By doing this, Peru not only will grow its economy but also reduce income inequality, accumulate human capital, and improve the lives of millions of its citizens. The self-employed street venders who spot the streets of downtown Lima will be able to easily register their businesses, gain easier access to capital, and expand their enterprises. The neighborhood mini-mart owner in the Lima shantytown will finally have access to adequate housing, healthcare, and education for her children. To improve the lives of millions of citizens, Peru needs to integrate its people into the formal labor market, thereby investing in the continued success of its economic future.

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[2]Reference titles originally in Spanish have been translated to English by the author.