Chapter 5
Reducing the Size of the Informal Economy in Latin America:
A Step Towards Increasing Competitiveness

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ABSTRACT

Authors analyze the current situation of competitiveness in the region and in selected countries, using available data. They diagnose the level of informal economy in the region. The chapter articulates how informality affects the competitive capability of a country. Recommendations are made on how to tackle informality, based on the current literature on the topic, previous experiences from other countries, and the authors' analysis. This chapter considers the importance of Colombia, Peru, and Mexico to Latin America in terms of economic size, population, and territory. Besides, these countries, along with Chile, form the Alianza del Pacifico (Pacific Alliance), a group of countries that constitutes a basic form of economic integration. Chile is excluded from this chapter since it shows significantly lower levels of informality than the other three alliance members.

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INTRODUCTION

Competitiveness is a must for development; Latin American countries do not perform well as research shows. The World Economic Forum in its Global Competitiveness Report analyzes competitiveness based on twelve pillars. The report found that the region lags in pillars such as institutions, infrastructure, labor market efficiency and innovation (World Economic Forum, 2018).

One of the challenges that Latin American countries face, in order to improve their competitiveness, has to do with high levels of the informal sector in their economies. The informal economy, also called shadow economy, has become a major issue in Latin American countries.

The International Labor Organization (2015, p. 4) refers to informal economy as:

(a)... all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements; and (b) does not cover illicit activities, in particular the provision of services or the production, sale, possession or use of goods forbidden by law, including the illicit production and trafficking of drugs, the illicit manufacturing of and trafficking in firearms, trafficking in persons, and money laundering, as defined in the relevant international treaties.

Because of its characteristics, it is considered a challenge to competitiveness; The Consejo Privado de Competitividad (Private Colombian Council on Competitiveness) (2017) cites Arango and Hamman (2013) who state that informal workers are less productive, additionally the Council also cites Cardenas and Rozo (2009) who found that informal enterprises show lower levels of productivity than their formal counterparts.

In Colombia, shadow economy accounts for 39,8% of GDP, with 33,5% related to informal and 5,3% to illegal activities; it also accounts for 64% of the economically active population, 54% of all enterprises and 25% of tax evasion (Asociación Nacional de Instituciones Financieras ANIF, 2018). The numbers of Colombia are similar to those of other Latin American economies. In Peru, Pérez and Cornejo (2015) cite the INEI (Peruvian National Institute of Statistics and Information) which states that over 70% of Peruvian workers belong to the informal sector but only contribute wuth 20% of the GDP. These numbers show that informal workers are less productive than formal workers, what is a threat to competitiveness in their countries.

Since the second half of the twenty century, different authors and institutions have provided definitions of the informal economy. The authors of this chapter consider the work of Ramos and Gomez (2006) who cite Roubaud (1995), who includes any economic entity that is not registered before the corresponding taxing institution, and they also cite Staudt (1998) who includes independent workers in the informal economy. There are more economic actors who can be included in the informal economy, however, the previous two authors provide a general idea of what informal economic institutions and participants are. Informal economies bring problems to countries such as lower tax collection, lower saving rates and it poses pressure on retirement systems since informal workers do not contribute to retirement funds.

This chapter starts with a theoretical framework about competitiveness and informality. Then, the authors will provide theoretical background on how competitiveness and informality are related. Afterwards, a diagnosis of the level of informal economy in the region will be performed using statistics about the size of the informal economy collected by Medina and Schneider (2018), as well as information on per capita GDP provided by the World Bank. Then, the authors will analyze the current situation of competitiveness in the region and in the countries selected for the study, using available data from the