

## Chapter 1

# Removing Barriers to Formalisation

## What is the issue and why is it important?

The informal economy forms a large part of the economies of many developing and transition countries. It comprises 42% of value added in Africa, 41% in Latin America and 35% in the transition economies of Europe and the former Soviet Union, compared with 13.5% in OECD countries. The informal economy provides employment and income for many who lose or cannot find work in the formal economy, and it includes a disproportionate number of women, young people and others from disadvantaged groups. For example, it has been estimated that informal employment accounts for 84% of women's employment in sub-Saharan Africa.

There is a continuum between informality and formality, with formalisation being a gradual process. Few firms follow all the rules governing enterprise behaviour and few follow none of them. Entrepreneurs make repeated economic calculations of the costs and benefits of following the rules, and embrace formality up to the point where the potential benefits outweigh the costs.

In the long term, informality does not provide a solution for poverty eradication. Countries with the highest *per capita* income have smaller informal sectors, while poorer countries have higher informal economy shares of total output. Thus, while informal enterprises may provide a short-term solution to a household's livelihood needs, creating an economy with a higher proportion of formal enterprises and jobs is important to long-term welfare creation, stability and poverty reduction.

While formalisation by itself does not promote enterprise growth in the short run, bringing more enterprises into the formal economy over the long term should:

- i) Provide higher quality, better paid, more sustainable jobs.
- ii) Reinforce the social contract between citizens and their state.
- iii) Strengthen the reliability of agreements between firms.
- iv) Build investor confidence (and increase investment).
- v) Broaden the tax base (potentially permitting lower tax rates).
- vi) Increase information on local enterprises to facilitate deal-making and strengthen frameworks for policy advocacy.
- vii) Reduce the cash economy and provide more resources for intermediation by the formal financial sector.
- viii) Improve access to business services, formal markets and productive resources such as capital and land.

Formalisation may also increase welfare in some marginalised groups by confirming their right to take advantage of market opportunities.

There is a growing body of research on business environments and their effects on economic growth and investment. Many donors sponsor research and interventions involving informal economy enterprises. However, few studies and projects focus

specifically on barriers to formalisation. The general assumption is that improving the enabling environment for all micro, small and medium-sized enterprises (MSMEs) will help informal firms move towards greater formality. This paper examines what has been learned about the main barriers to formalisation of enterprises and what good practice examples exist for reducing these barriers.

## The current evidence: Informality, economic development and growth

The “Doing Business” initiative of the International Finance Corporation is generating benchmarks and indicators for different aspects of the business environment world-wide. Its 2005 report contains data for 145 economies on starting a business, hiring and firing workers, registering property and getting credit. Countries performing better in these areas (simpler procedures, shorter waits and lower costs, etc.) have smaller informal economies. Complementary statistical analysis has shown, however, that no single indicator is a key factor in promoting formalisation. This is because countries that did well in one aspect of the business environment also did well in others, *e.g.* countries with high business start-up costs also had high worker dismissal costs. The effects of the various factors are therefore difficult to untangle statistically.

## Barriers to formality from the entrepreneur’s perspective

Much of the available research focuses on barriers to growth in informal and smaller enterprises, rather than on the actual formalisation decision. Nonetheless, it is reasonable to infer from the research that some barriers to growth, *i.e.* those that impact on the smallest enterprises, are likely to correlate with barriers to formalisation. The sub-set of material on barriers to formalisation supports this, with regulatory and administrative barriers standing out as a particular concern. Barriers to formalisation fall into several categories including: i) regulatory barriers; ii) administrative barriers; iii) fees and financial requirements; iv) corruption in public administration; v) socio-cultural attitudes; vi) lack of key business services; and vii) criminality. There is a strong global body of evidence to suggest that regulatory, administrative and financial barriers, along with corruption, have the most direct influence on the formalisation decision. Reducing these barriers will help informal enterprises move along the continuum towards a greater degree of formality.

- i) **Regulatory barriers** are inappropriate requirements stemming from governments that do not appreciate the impact on firms (particularly smaller firms) of additional reporting, inspection and other compliance procedures. The time entrepreneurs require to maintain and grow their business is not valued. Various studies have identified burdensome and costly government regulation as the most significant determinant of informality, and as a source of corruption. In general, years of poor quality law-making in developing countries have created a tangle of complexity and inconsistency that presents an almost insurmountable obstacle to the enterprises seeking formality. Regulatory (and administrative) burdens have a strong cumulative effect on the business environment.
- ii) **Administrative barriers** stem from the way regulations are enforced. They include: excessive paperwork, inefficiency/delayed decisions, inaccessibility of services, bureaucratic obstruction and abuse of authority. These barriers have many sources, including over-complicated regulations, out-dated ways of working, lack of capacity, over-centralisation of authority, distrust of the private sector and – linked to all of this – corruption. In many countries, little effort has been made to raise awareness among

public servants of the private sector's needs, nor to create a more service-oriented culture with respect to entrepreneurs (as opposed to a culture that sees its role as one of control and enforcement).

- iii) **Fees and financial requirements** consist of regressive fees that penalise smaller firms, overly complex tax regulations and poor tax and tariff administration. In a number of countries, initial business registration and licensing fees are set at too high a level. Informal enterprises shy away from joining tax regimes for other reasons: they are worried about tax levels; they do not understand how to comply with tax requirements; they fear the behaviour of revenue officials; or they do not believe they will receive services in return for payment. Unfortunately, little work on improving tax administration focuses closely enough on the informal economy to understand which of these obstacles are more problematic and in need of attention. Too little tax reform work considers alternative, more indirect approaches to income-based taxation, which is a burden to smaller firms.

Financial barriers are integrally entwined with regulatory and administrative barriers related to the general registration of business activity and licensing for operations in specific sectors. The main registration obstacles are excessive costs and time spent dealing with bureaucracy. Registration and licensing become confused in some developing countries: registration should be a straightforward administrative process with little discretion involved, but it often takes on aspects of sector-specific licensing, such as site visits, annual re-licensing and review by committee of the application. This can act as a significant disincentive to registration. Some countries use “licences” as a primary means of annual revenue collection for local authorities (as in East Africa). In a number of countries, entrepreneurs must travel to the capital or other distant towns to conduct these procedures.

Informality is one way of avoiding labour laws and their associated costs (social insurance, etc.). In many countries businesses face major hurdles in taking on their first “formal” employee. The additional costs related to labour regulations are estimated to be the most important disincentive to participating in the formal economy for small firms in Latin America.<sup>1</sup> Overly rigid labour laws often hurt the people they are meant to protect, keeping employees in the informal economy and inhibiting economic growth that could create new jobs.

- iv) **Corruption** is a major factor deterring formalisation, as businesses stay off registers and tax rolls in order to minimise contact with corrupt public officials. A study of 69 countries found a direct link between decreases in corruption and increases in the size of the formal economy. Corruption erodes the trust that businesses have in government and leads informal businesses to conclude that their long-term prospects in the formal economy are poor. Therefore, efforts to reduce barriers to growth and formalisation will be thwarted if corruption is not also tackled. Reducing and simplifying regulatory and administrative requirements diminishes opportunities for corruption, but this also explains why there can be a reluctance to pursue such reforms.
- v) **Socio-cultural barriers.** In some countries, there is a degree of resistance to formalising because of socio-cultural obstacles. The informal economy comprises strong networks of trust and interdependence, often cemented by collective historical experience, *e.g.* of oppression or social exclusion. When an informal entrepreneur has a history of

successful trade with other informal entrepreneurs in the same social group, the motivation to formalise can be lacking. In some failed or very weak states, the informal economy is entrenched and has had, for many years, to self-regulate and carry out many of the functions of the state.

- vi) **Lack of key business services.** Some argue that having more services (finance, registration of land titles, infrastructure, public procurement opportunities, management support, etc.) available for formal businesses attracts informal enterprises into the formal economy. Increasing the potential benefits for formal enterprises might correspondingly increase tolerance for the compliance costs of rules and regulations. This hypothesis is compelling. Unfortunately, it is virtually impossible to prove. Whether or not formalisation has been an explicit goal of services improvement, most monitoring and evaluation of the new services did not consider their impact on formalisation, focusing instead on business income, job creation and other quality-of-life and work improvements. What little evidence could be found raises some doubts as to the strength of a service-driven formalisation motive.
- vii) **Criminality.** Some individuals are reluctant to provide information about their personal wealth and circumstances to government officials, because they are concerned that this information may be passed to people involved in serious and organised crime and make them targets for criminal activity.

### Knowledge gaps and different approaches to informality

While much is known about how barriers restrain private sector growth both in the formal and informal economies, there is little specific research into why firms do not formalise. Understanding is limited of which barriers are the most significant and how they impact on the decision-making process, although much can be deduced from surveys of general barriers to growth. Nor does the research have much to say about the links between formalisation and enterprise performance, or about short-term *versus* long-term effects.<sup>2</sup> There is scope for further primary research in these and other areas.

The informal economy is complex and donor interventions should be based on sound research. There is a risk of making false assumptions. For example, research and interviews with donors revealed a predominant view that many informal economy workers would prefer to return to formal waged employment as soon as it became available. However, there is credible evidence to suggest that this is not necessarily the case: in a recent survey in South Africa, the majority of informal sector respondents indicated that they would prefer to remain in business rather than take a job if one were available. Another recent survey of women entrepreneurs in the MSME sector in Ethiopia found that three out of four would not forego their current businesses if offered a permanent job elsewhere.

The heterogeneity of the informal economy and varying donor emphases have created a variety of approaches to understanding and addressing the informal economy. Two potential conflicts have emerged:

- i) **Improving livelihoods within the informal economy while encouraging formalisation.** Some researchers and donor programmes view the informal economy as a long-term, structural feature of modern economic development. Given this, some interventions are aimed at improving the welfare of the people who find themselves in the informal economy, rather than helping them to formalise. Other donor interventions consider formalised economic growth to be a central goal of development and a primary driver

of poverty reduction. These are accordingly focused on encouraging formal economy growth. In between these two views, there is a place for interventions that help actors in the informal economy to take gradual steps in the formalisation process, for instance by creating associations with a formal status to facilitate access to such services as micro-credit, insurance, land tenure and physical market places. The challenge is to determine how interventions can be devised that improve the livelihoods of the poor while not removing incentives to formalisation.

- ii) **Improving employment conditions for informal economy workers versus increasing competitiveness of the local private sector.** Some approaches view the informal economy from a labour-market perspective and look for ways to reduce employment deficits and to improve the quality of formal work opportunities. This approach has the potential to conflict with approaches that emphasise the competitiveness of informal economy enterprises, the need for workforce flexibility to maintain comparative advantage and the need to keep employment law compliance burdens to a sensible minimum. The relatively new “Decent Work” approach seeks to strike a carefully constructed balance between helping enterprises grow while also promoting improved work conditions, but its impact is not yet well understood.

### Good practice in removing barriers to formalisation

There are a number of ways of trying to reduce informality. The following is a summary of current donor good practice in reducing regulatory and administrative barriers to formalisation:

- i) **Support broad programmes of regulatory reform. Introduce Regulatory Impact Assessments.** Institute programmes of reform that examine regulatory burdens from the enterprise point of view. Programmes should be informed by surveys of the barriers of most concern to enterprises, including those that are identified as barriers to formalisation. Choose sectors according to their capacity to generate growth and employment. New laws should be subject to assessments of their impact on MSMEs, including the formalisation decision.
- ii) **Design measures to create a business-friendly culture in government and to improve service provision.** Even without significant increases in resources, there are steps that can be taken to improve the delivery of services to business by government. Donors should support efforts to create service charters in ministries and local administrations. They should also support one-stop shops in accessible locations to help firms understand and comply with their obligations and play an intermediary role between enterprises and government services, pressing the latter to improve service delivery when necessary.
- iii) **Simplify official administration for businesses.** Review and reduce paperwork for businesses and make use of information technology (IT) where possible. Keep official forms to a minimum. Consider exemptions for smaller firms, or more appropriate thresholds for entering into regulatory regimes.
- iv) **Avoid retroactive taxation for businesses that formalise.** Enterprises will be reluctant to formalise if they fear a large tax bill.
- v) **Simplify tax administration.** Tax administration is more often cited as a problem than tax rates. Consider single taxes for MSMEs as a way of reducing the number of payments. Offer different payment options, one-off or by instalment.

- vi) **Share information on what taxes are used for**, and how businesses will benefit from enhanced services. Evidence suggests that compliance rates go up when businesses know what they are getting in return for their payments.
- vii) **Rationalise business registration and licensing regimes**. Make registration a simple, administrative process that is separate from licensing. Use IT where possible. Separate the function of revenue generation from business registration and licensing. Remove registration from (usually overburdened) courts wherever possible.
- viii) **Limit licensing to those activities where it is justified** on health, safety, environmental or other grounds. Avoid multiple licences and make it easier to submit applications. Eliminate licensing for as many firms as possible.
- ix) **Make it easier to register business and producer associations**. Socio-cultural traditions can be transformed from barriers to opportunities through the formalisation of business or producers' associations. Whilst barriers to formalisation may seem insurmountable to individuals, it may be easier to encourage the formalisation of such producer groups and, through them, to make the benefits of formalisation available to individuals.
- x) **Reduce registration fees and statutory requirements**. Make sure that fees are set at a reasonable level and that any requirements, *e.g.* for fixed premises or capital, are fully justified.
- xi) **Promote labour law reform** which protects essential rights while making it easier to hire and fire workers and to employ people on flexible contracts.

In addition to these micro-level reforms, four higher-level business environment reforms are important to support efforts to encourage formalisation:

- i) Initiating dialogue with participants in the informal economy, in order to understand their constraints (including resistance to formalisation), is vital. Town hall meetings, radio talk shows and focus groups are just some of the ways that have been used to include the informal economy in policy making.
- ii) There are decentralisation initiatives underway in many parts of the world; evidence suggests however that many local authorities are ill-equipped to undertake greater responsibilities and that they do not understand the needs of informal entrepreneurs. Worse, some local authorities view enterprises primarily as a source of short-term revenue. Donors can support programmes that build the capacity of local government to support improved services to business, enterprise growth and formalisation.
- iii) Efforts to tackle corruption are likely to have a significant impact on restoring entrepreneurs' confidence in public administration and their willingness to formalise.
- iv) The potential for misunderstandings around issues of informality speaks to the need for donors to co-ordinate their activities in this area, permitting a complementary, gradualist approach to formalisation.

## Policy and practice recommendations for donors

In addition to the specific recommendations aimed at removing barriers and at supporting measures, a number of policy and practice recommendations for donors emerge:

- i) Develop a commonly shared toolkit that encompasses the full range of successful donor interventions that have an impact on formalisation.
- ii) Promote formalisation by creating a regulatory environment that is generally enabling.

- iii) At the same time, work with willing partners to remove barriers to enterprise growth and formalisation at local level. Wholesale legal reform is not always possible, but progress can still be made to streamline administration (as through one-stop shops).
- iv) Support measures to reduce corruption at the main interfaces between government and business in the process of formalisation (particularly in registration and licensing procedures).
- v) Educate government officials at local and national levels about the importance of the informal economy and the role they can play in increasing formalisation by offering improved services. Demonstrate that facilitating long-term growth of the tax base is preferable to extracting short-term gains and encouraging firms to hide their activities.
- vi) Ensure that programmes to increase welfare in the informal economy do not reduce incentives to formalise. In return for assistance, require a *quid pro quo* from informal enterprises in terms of movement towards formalisation.
- vii) Support dialogue between government and informal enterprises (or their associations) to reveal barriers to formalisation and build trust and understanding on both sides.
- viii) Consider the merits of longer-term interventions, such as reforming regulatory and administrative barriers; changing the culture of government takes time. Where longer-term interventions are not possible, adopt more modest and targeted objectives.
- ix) Assess the capacity of local governments to implement policies to reduce barriers to formalisation and take steps to plug gaps between centrally-approved initiatives and local capabilities.
- x) Undertake and share further research on the impact of reforms to the enabling environment on formalisation.

### Notes

1. See Tokman (1992). The IDB also estimated that restrictive labour laws accounted for a 6% increase in the informal sector share of total employment in Latin America between 1990 and 1996 (cited in Krebsbach, Karen, *Global Finance*, 1999).
2. There certainly are cases where the costs of formalisation have reduced enterprise profits in the short run, and there are cases where investment climates are improving but informal economies continue to grow in the short run. However, there is no denying the strong correlation between proportion of GDP in the formal economy and overall economic well-being of countries, as cited at the beginning of this paper.

### Further reading

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