

SUPPORTING BUSINESS ENVIRONMENT REFORMS

PRACTICAL GUIDANCE
FOR DEVELOPMENT AGENCIES

ANNEX: HOW BUSINESS ENVIRONMENT REFORM CAN PROMOTE FORMALISATION



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DCED

The Donor Committee for Enterprise Development

Supporting Business Environment Reforms: Practical Guidance for Development Agencies

Annex: How Business Environment Reform Can Promote Formalisation

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Preamble

In 2008, the Donor Committee for Enterprise Development (DCED) published guidance for donor and development agencies in their support of business environment reform in developing countries, entitled *Supporting Business Environment Reforms: Practical Guidance for Development Agencies*.¹ The guidance has drawn attention to how business environment reform affects the informal economy and the decisions taken by informal private enterprise owners and managers.

To address this, the DCED commissioned research into how donor and development agencies support reforms that affect the informal economy. The findings of this research are contained in the DCED 2009 publication *Business Environment Reforms and the Informal Economy*.² In 2010, the DCED hosted a conference in Cape Town, South Africa, to explore the kinds of reforms that allow informal economy actors to formalize, access new markets, and contribute to growth.³

This annex describes the principles and practices donor and development agencies can employ to deal with the concerns raised by a large informal economy and the influence of reforms on the formalization of private enterprises. This document builds on the principles and recommendations of the original 2008 donor guidance.

This annex to the donor guidance represents consolidated views of the members of the DCED. Although every possible effort has been made to reach consensus on the content, it does not necessarily reflect the views of each and every agency member of the DCED. Likewise, it does not necessarily reflect the formal view of the management and governing bodies of the development agencies members of the DCED or the governments they represent. The information provided is not intended to serve as legal advice. Copying or transmitting portions or all of this work requires permission from the DCED. The DCED encourages dissemination of its work and will grant permission promptly. All requests should be directed to the DCED Secretariat by email: Coordinator@Enterprise-Development.org

¹ The donor guidance is available from:
<http://www.enterprise-development.org/download.aspx?id=586>

² Report by Clifford Zinnes available from:
<http://www.enterprise-development.org/download.aspx?id=1489>

³ Conference papers are available from:
<http://www.enterprise-development.org/page/informal-economy-conference-2010>

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Key messages:

INFORMALITY AND ITS CAUSES

The informal economy is the result of a complex mix of economic, social, and political factors that affect a business owner's decision to comply or not with the legal and regulatory framework. Many of the drivers of informality are **beyond the reach of business environment interventions**.

Some national economic policies may contribute to greater levels of informality. In an open and highly competitive economy, local firms may choose to act informally to reduce costs. It is important to assess these influences and create mechanisms that **help domestic firms manage competition in a sustainable manner**.

Not complying with regulatory requirements reduces the cost for producing goods and services by informal actors, which may create **unfair competition to those who are complying and bear formal regulatory cost**. Such situations may force already formal businesses to move back in informality to compete or even just to sustain their business. Nevertheless, the costs of operating in the informal economy—although they may not be recorded—are estimated to be considerable.

OBJECTIVES OF REFORM IN THE INFORMAL ECONOMY

While often characterized by high levels of poverty, social exclusion, and exploitation, the informal economy can be a **source of innovation and economic growth**. Thus, while **the formalization of informal firms is desired**, so too is **improving safety, productivity, security, and social protection of informal firms and workers**.

Reforms should distinguish between those that **reduce the overall levels of informality** (i.e., reforms that lead to broad-based economic growth) and those that **increase the rate of graduation into the formal economy** due to increased benefits from operating formally.

REFORMS THAT RESPOND TO THE CAUSES OF INFORMALITY

While **the barriers to enter the formal economy vary**, labour and taxation laws and regulations are the most common obstacles. Promoting formalization and strengthening the rule of law involves a stepped process that encourages informal actors to **move toward greater degrees of compliance and formality**. Measures may need to include a proper balance of incentives as well as compliance.

Stakeholder engagement is a fundamental element of effective business environment reform. However, the concerns of informal actors are often excluded from reform processes. It is important to ensure that informal actors have a stake in the design and management of reform processes. This will often require support to **better organize informal actors** and ensure their concerns are **effectively represented in public-private dialogue processes**.

Structures for **greater accountability** between the state and informal actors are important and business environment reform is a process that leads to a better relationship between the state and private informal actors. While governments at all levels should become more accountable to the business community, especially with regard to the provision of public services, informal actors should also be able to seek justice through the courts and other mechanisms that enshrine rights and remedy complaints. Informal actors require **opportunities to participate in government planning and decision-making processes, and mechanisms to provide feedback on government services**. In some cases it may be useful to engage representatives of the social

economy, such as the co-operative sector, to extend services and opportunities to informal actors.

High quality laws and regulations are essential if formalization is to be nurtured. The rule of law is weak in many developing economies. **Good business environments promote openness and transparency**—these are critically important to informal economic actors. Informal operators have in general very low levels of literacy and an enabling legal and regulatory environment needs to take account of such low capacity for informal operators to understand and comply with business frameworks.

Access to information is critical for informal actors. This includes access to government information as well as access to market information.

DESIGNING REFORM PROGRAMS

Careful diagnosis of the multiple causes of informality is essential if business environment reforms are to succeed. This involves an **assessment of the business environment**, as well as of the **broader governance systems** in which businesses operate. The contexts and needs of informal actors vary greatly and also need to be carefully assessed. Reform processes should respond to the specific concerns of these actors and should be placed in the context of the importance and characteristics of informal business units within national economic activity.

COMPLEMENTING REFORM PROGRAMS

Holistic approaches are needed and consideration should be given to programs that **complement business environment reforms** and help new and growing firms to take advantage of the opportunities created by a better business environment.

I Introduction

Donor and development agencies supporting business environment reforms are increasingly concerned about those who fall outside the legal and regulatory framework and are unable to take up the new opportunities an improved business environment provides. Many developing economies contain a large informal economy. While this informal part of the economy is typically characterized as poor, exploitative, insecure, and unsafe, it can also be a safety net for many vulnerable groups including women and indigenous entrepreneurs, as well as a place for innovation. The informal economy is a significant contributor to the domestic production of many developing countries, although this contribution is often unseen or difficult to measure and, while it remains informal, does not contribute to sustainable growth.

II Defining informality and its causes

Informality is difficult to accurately define. Various degrees of informality can be found along a continuum between an enterprise operating completely informally to one that complies with all laws and regulations. For example, an enterprise may be officially registered with all the necessary authorities, but engage in informal activities by employing workers informally or trading with informal suppliers.

The informal economy is made up of different kinds of firms. Some are microenterprises that are largely survivalist in nature, with very limited potential for growth. Others are larger and more mature, with a greater potential for growth should they gain better access to markets and resources through an improved business environment. While informality can range from survivalist, livelihood-based enterprises to growth-oriented enterprises, enterprise growth is typically associated with increasing degrees of formality. There are also different kinds of informality (e.g., unregistered enterprises, informal workers). Thus, the informal economy contains a diverse range of enterprise actors and requires careful description and analysis.

While the terms “private sector” and “private sector development” (as used in the donor guidance) encompass all forms of privately owned enterprise, formal and informal, many informal economic actors do not identify with these terms. Informality involves degrees of exclusion where firms operate on the edge of the formal (or official) economy. Thus, even when referring to the broader business community, it is important to use language that is inclusive and accurate.

III Business environment reform and informality

Because there are different categories of informal enterprises, the linkages between business environment reform and these enterprises will vary. Donor and development agencies should identify these links and explicitly show how business environment reform will affect these informal enterprises.

Because there are different drivers of informality, there are different starting points and priorities for reform programs. For example, reforms designed to address informality that is created by war and conflicts will differ from those used to address informality created by exclusion or inequality. While business environment reform is not the only intervention required to address the concerns of informality, donor and development agencies should pay greater attention to understanding these distinctions and to ensuring that not all reforms targeting the informal economy are pursued in the same way.

IV The objective of reforms that address informality

Business environment reform has typically sought to encourage the formalization of informal enterprises. By improving the legal and regulatory framework in order to make formalization and operation easier and cheaper, governments and their development partners (including business

membership organizations, and donor and development agencies) encourage informal actors to become formal and participate more in the mainstream, formal economy. This includes efforts to help local firms compete effectively in the global economy.

However, formalization is not the only objective of business environment reform. Because informal economic activity can promote innovation and can act as a buffer to economic shocks that developing economies regularly face, an additional objective of business environment reform is to improve the conditions in which informal actors operate. Reforms can enhance the positive effects of informality while making it safer, protecting the vulnerable, and encouraging equity. A dynamic, competitive, and growing economy will display movement between the formal and informal economies.

V Reforms that respond to the causes of informality

Because informality is created by different social, economic, and political elements, donor and development agencies should design their programs based on a clear analysis of these elements. Although not exhaustive, the following typologies reflect the ways business environment reform can be used to address informality. Often, more than one of the following factors play a part in contributing to the size of the informal economy. Thus, donor and development agencies and their program partners may need to blend these elements when designing a reform program.

- 1. Poor general business environment:** Many developing countries have business environments that are difficult and costly to comply with. Additionally, informal enterprises in these countries are often unaware of their legal obligations. Even if they know about them, it can be very difficult to comply with them; instead of being short, simple, and cheap, regulations are numerous, lengthy, and expensive. Formalization involves physical visits to many agencies through an opaque process that involves a high degree of discretionary power by government officials and the frequent need to pay bribes. The World Bank's annual *Doing Business* reports provide a valuable international comparison of some of these factors. Business environment reform that makes it easier and cheaper to register and license an enterprise, while removing discretionary power and moving to a clearer rule-based system, can foster formalization. Of course, these reforms need to be communicated to informal actors.
- 2. Few incentives to formalize and poor government services:** Many informal enterprises associate formalization with high regulatory burdens and harassment. Informality allows the enterprise to hide from government officials. While harassment by the police and various other officials is a common experience for informal enterprises, it is often treated as a cost of doing business informally. Informal enterprises fear that by registering or obtaining the licenses and permits they officially require, they will become more visible to government and subject to increasing costs. Furthermore, formalization in developing countries does not usually bring many benefits in terms of government services. Enterprises operating in poor areas are subject to regular power outages, the lack of rubbish removal, and ailing infrastructure, whether they are registered or not.
- 3. Exclusion and marginalization:** Certain groups, such as women and indigenous peoples, are often disproportionately represented in the informal economy. This is typically a result of social conditions that exclude or marginalize certain groups and make it more difficult for them to engage in formal markets. Business environment reform that addresses these concerns will focus on improving dialogue with excluded and marginalized groups in order to better understand their experiences and the factors that contribute to this situation. Supporting the development of representative organizations and public-private dialogue processes are cornerstones in building a better relationship between government and the private sector. Governments at national and local levels are encouraged to treat businesses as clients and to establish regular and effective public-private dialogue processes. It is important

that this dialogue includes informal enterprises so as to ensure that their concerns can be clearly identified.

- 4. Informality due to conflict and other forms of social disruption:** Informality can be caused by external shocks and social disruptions that create instability and force people to operate outside of the formal legal system. Armed conflict, famines, and natural disasters can create situations in which the rule of law is weakened and informal behaviour increased. Business environment reform in these contexts may focus on ensuring that the private sector governs itself well, reduces corruption, and adopts international norms of behaviour and reporting. Reforms are encouraged to reinforce governance and help firms to work through government structures.
- 5. Reducing costs and maximizing benefits:** Many informal business owners trade off the costs of formalization with the benefits. Many countries with large informal economies make it difficult to formalize and offer few benefits. Thus, reformers should carefully assess the costs and benefits of formalization and identify measures that enhance the benefits of formalization, such as access to finance and differentiated tax schemes.

Some agencies have applied a Business Sophistication Model to classify firms according to their degree of formalization along a number of dimensions: legal, financial usage, technological, marketing, record-keeping, and exports. This classification allows for the grading of enterprises along a continuum ranging from the least sophisticated and most informal (in which firms have no formal registration), to the most sophisticated and formalized. Sampling of firms for this kind of assessment requires careful planning. It is important to ensure sampling encompasses rural-based firms, those that are owned and managed by women, home-based and family-owned firms, and agricultural and non-agricultural firms. Business environment reforms should be tailored to take such diversity into consideration. Of course, subsistence enterprises are unlikely to immediately formalize following reform.

VI Designing reforms that promote formality

While it is tempting to dive into specific reforms targeting the informal economy, it is often better to consider the big picture first and to understand the broader relationship that exists between formal rules and institutions and informal economic actors. It is important to analyze the political economy of reform in any one country. Rules and regulations that reflect social norms and values are often more effective and enforceable than those that ignore these factors.

Reforms targeting the informal economy are advised to respond to the ambitions and motivations of informal actors. Many informal enterprise owners and managers do not believe they have a choice other than to operate informally. Thus, they should be offered affordable choices that lead toward formality.

Donor and development agencies should prioritize program requirements based on the most feasible and strategic options. The challenge is to identify the key reforms that will stimulate a quick, strong supply response while laying the groundwork for the next round of essential reforms.

While there are many variations based on country and region, there are a number of common business environment domains where policy, legal, or regulatory reform impacts on the formalization of informal firms:

- 1. Business registration and licensing:** Rationalizing and streamlining business registration and licensing regimes (in order to make registration a simple administrative process that is separate from sector licensing) promote formalization.
- 2. Taxation policy and administration:** Inappropriate taxation systems encourage informality. Tax compliance can be eased by introducing more transparent and simplified tax reporting

requirements, improving tax inspections, reducing the number of payments, offering different payment options, and differentiating tax schemes for microenterprises and farmers.

3. **Land ownership and titling:** Land ownership and the capacity to raise capital through land-based collateral is a key concern for many informal enterprises. Reforms that redress incomplete cadastres and onerous or costly land registration systems, and enable female ownership of land and assets may be appropriate.
4. **Labour and labour-related issues:** Appropriate and effective regulation is necessary for reducing the burden and cost for enterprises complying with the regulatory requirements while maintaining workers' protection. The challenge of balancing enterprise growth and workers' protection calls for an active role of the state, particularly in implementing a legal framework for the labour market, basic social protection (e.g., health and safety, minimum income), and skills development.
5. **Judicial reform:** This often involves reducing the transaction costs and improving access to formal dispute resolution channels, strengthening and improving the quality of customary and traditional governance methods, improving linkages between (and greater awareness of) formal and informal systems of justice, and improving access to justice in bureaucratic administration.
6. **Intellectual property rights:** Trademarks and other property rights are sometimes used illegally by informal business units operating in diverse sectors. Campaigns to replace illegal products with legally protected products should aim to provide economic opportunities for operators based on consumer benefits and protection under legal operation.
7. **Financial services:** Although informal finance mechanisms and microfinance institutions have received support to help informal enterprises gain access to finance, the process of formalization involves reforms that increase the access of poor women and men to the full range of financial services.
8. **Access to information about business regulation and rules:** This may include information campaigns, availability of relevant information online, and outreach to remote locations to help firms understand and comply with their obligations. Reforms in this area may also include the establishment of collateral laws and the reform of collateral registries.
9. **Incentives for reform and communicating these to informal enterprises:** Formalization should introduce the benefits of compliance with the legal and regulatory framework. Micro and small enterprises should see formalization as an opportunity for greater access to markets and growth.

Reform programs should target representative organizations, such as informal business membership organizations, workers' organizations, and other informal enterprise and worker coalitions, but should not limit their engagement to these groups. It is recognized that many informal enterprises prefer to stay hidden and this creates particular challenges to formal dialogue. Because many participants in the informal economy are unorganized and unrepresented, donor and development agencies and their program partners should use the media to conduct a communications strategy that reaches all members of the business community. When doing this, donor and development agencies and their program partners face the challenge of the low level of literacy among poor and informal business actors. Thus, communications and advocacy strategies accompanying business environment reforms need to take into consideration the informal economy instead of focusing on the formal business sector.

Donor and development agencies should work with their program partners to create a platform for dialogue among informal enterprises, government organizations, the formal business community, and other representative organizations. All partners must establish a broad-based

consensus on the priorities for reform based on empirical evidence, a common understanding of real impacts and risks, and a thorough knowledge of local contexts and environments. It may also be helpful to establish specialized facilities, such as one-stop-shops and help centres that can guide and advise micro and small enterprises on compliance processes.

It is important to highlight the anticipated and actual benefits of reform so that all actors recognize how this will improve the circumstances of all private enterprises, especially informal enterprises. This is likely to involve sensitizing relevant stakeholders and raising their awareness of the needs for and benefits of reform. Government should be encouraged to realize that formalization is not only about increased tax revenue, but also about the need for better government services.

VII Complement business environment reform with supply-side responses

Economic growth that creates a greater demand for formal employment is a powerful force that pulls informal businesspeople and workers into the formal economy and into more productive and decent employment.

On its own, business environment reform is a necessary but insufficient response to the challenges faced by informal actors. Many of the drivers of informality are beyond the reach of business environment interventions. Thus, consideration should be given to program interventions that complement business environment reform, such as financial and business development services. These include access to resources that boost enterprise productivity and growth, education and health services, housing and infrastructure; reduce corruption; and create social safety nets. There may also be a need for services that help firms understand and tackle the steps required to comply with the relevant laws and regulations and remain compliant. This requires policy coherence and coordination.

VIII Conclusion

Donor and development agencies and their program partners need a systematic way of learning about the effectiveness of reforms that target the informal economy. This requires continued investment into research, knowledge management, training, and support for communities of practice. Greater importance should be assigned to conducting rigorous impact evaluation on pilot interventions in experimental settings. Learning from these evaluations is extremely useful for donor community and government policymakers in formulating their interventions to reduce informality. Donor and development agencies are encouraged to work together, through the DCED and other mechanisms at international and national levels, to capture the experience of what works and what doesn't work, and to document this in "how to" manuals and case studies.