

# Business Environment Reforms and the Informal Economy



**DCED**

The Donor Committee for Enterprise Development

# **Business Environment Reforms and the Informal Economy**

*Discussion Paper*

Donor Committee for Enterprise Development

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# Abbreviations

BE	Business Environment
BEWG	Business Environment Working Group of the DCED
BER	Business Environment Reform
BoP	Base of the Pyramid
CLEP	Commission on Legal Empowerment of the Poor
DCED	Donor Committee for Enterprise Development
DFID	Department for International Development
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
GEF	Global Environment Facility
GDP	Gross Domestic Product
IE	Informal Economy
IFC	International Finance Corporation
ILO	International Labor Organization
LAC	Latin America and the Caribbean
M&E	Monitoring and Evaluation
MCC	Millennium Challenge Corporation
NGO	Non-governmental Organization
OECD	Organisation for Economic Co-operation and Development
OSH	Occupational Safety and Health
Sida	Swedish International Development Agency
SME	Small and Medium-scale Enterprise
SNG	Subnational Government
SSA	Sub-Saharan Africa
TA	Technical Assistance
TREs	Transition Economies
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
USAID	United States Agency for International Development



# Executive Summary

Great strides have been made over the last decade in developing countries to clarify, simplify, and make more predictable the legal and regulatory environment within which business operates, on the one hand, and to strengthen the institutions required to protect property rights, including contracts, on the other. Yet in some respects business environment reform (BER) still faces several unresolved challenges. Principal among these relate to the apparent reluctance of the majority of businesses—usually those that are micro and small—to “formalize,” which, roughly, requires becoming officially registered as a business and/or as a taxpayer. By remaining informal, a firm operates in an *informal economy* (IE) and is unable to take full advantage of the legal, financial, and marketing benefits that, in principle, the judicial, banking, and economic systems of its country offer. This holds back a significant share of the population—perhaps as many as 4 billion people—from attaining its economic potential and, as a result, may leave a large market, whose value some observers place at \$4 trillion, untapped.<sup>♦</sup> Though it varies by region and gender, a country’s IE can reach 70 percent of official GDP. Most frustrating, in spite of all the innovative and extensive BER carried out to date, the size of the IE is actually *growing* in most regions. This situation perpetuates the poverty and lack of dignity of those living at the “base of the economic pyramid” (BoP), thereby exacerbating socio-economic inequality and, through its impact on youth unemployment, perhaps generating terrorist recruits.

The implications of widespread informality for developing countries appear extremely serious: lost tax revenue limits the scope of the state to provide services,

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<sup>♦</sup> References in this summary are in the footnotes associated with the identical text in the body of this paper.



and increases dependence on aid. If a high proportion of business activity operates outside the scope of regulation and policy interventions, governments are unable to shape macro-economic outcomes through policy. The need to stay ‘under the radar’ restricts the potential for firms to grow, while the absence of predictable, enforceable rules increases risks, and corruption. Finally, the absence of a ‘fiscal-social contract’ between the state, business and citizen, represented by the exchange of regulatory compliance and tax on the one for hand, for services and the rule of law on the other, undermines democracy and the emergence of effective states.

The purpose of this paper is to provide guiding principles and advice to donor and development agencies, and their program partners, on how BER programs might further contribute to the needs of the BoP by reducing informality and encouraging informal business to start operating formally. Of particular concern is avoiding policies that increase formalization but concomitantly are likely to increase poverty. The paper takes the objective of BER to be economic growth and gender-neutral poverty reduction and *not* formalization, though the latter is hypothesized to contribute to both of the former. The units of interest include informal small and micro businesses—subsistence (“survivalist”) activities as well as those with significant growth potential, medium and larger firms that operate formally (for their health might be aided or abetted by the smaller informal firms), and those larger firms that may appear formal but engage in systematic under-reporting or informal (or sometimes corrupt) agreements and relationships to prosper.

Toward this end, the large body of related literature is interpreted through two complementary lenses, cost-benefit analysis and economic empowerment. The former lens views the formality decision of the economic agent as one of rational choice, where the transaction costs in terms of money, time, and knowledge (required to overcome the high-cost impediments to participation in markets and to access key inputs) are weighed against the benefits that formality might confer in terms of greater access to goods and services (both economic as well as those related to social protection) at their existing level of quality and reliability. The latter lens views the causes of informality—the aforementioned components of the cost-benefit decision—as the consequences of a nation’s abrogation of certain human rights. These rights relate to access to justice, security of property rights, the fulfillment of labor rights (as specified in the *Fundamental Principles and Rights at Work* and the *Decent Work Agenda*), and business rights (access to finance, limited liability, insurance, ability to use formal contracts, etc.).

These lenses are somewhat sequential: lack of economic empowerment diminishes the degree that public and private services are accessible and thus influences the cost-benefit calculus of economic agents on whether to remain informal. Likewise, the decisions of these agents carry externalities that result in much of the

country remaining trapped in a low-level economic—and social—equilibrium. The paper argues that the uneven successes of BER efforts to date are not due to fundamental mistakes or errors in those efforts but are consequences of larger economic development challenges contributing to a growing BoP. This different emphasis leads to a call for greater attention to complementary policies—and economic empowerment, in particular.

## Key Questions Addressed in the Paper

Applying the dual framework allows a set of questions to be addressed.

**1. How does business environment reform affect the size of the informal economy?** The BE affects size of the IE through its effect on specific areas of informality (labor, tax, energy, product, financial and capital market, asset, and adjudication), which are discussed in detail. The paper finds that BERs primarily focus on reducing the costs of compliance. It argues for greater attention to reforms that produce benefits to formality and thus are related to empowerment: more secure property ownership, a safer work environment, greater availability to low-cost alternative mediation and dispute resolution, easier access to finance.

The effect of BER on size of the informal sector also has two temporal considerations. First, while BER may have some desirable short-run effects, (e.g., increasing the number of formal economic actors), to have a sustained impact it must stimulate investment by the poor. This will require incorporating into BERs some of the reforms—as well as approach to reform—promoted by the legal empowerment movement. Second, given the existence of fixed costs in the formality decision the IE is “sticky,” i.e., a small improvement or worsening in the BE can cause economic agents to change their formality status but not return to the previous status if the BE change is reversed.

The paper also examines how the existence of informality can influence the effectiveness of BER. Among the channels include biased policies due to lack of representation by micro- and small-firm owners in formal decision making, reduced BER impact when so much economic activity escapes the regulatory net, weakened institutions due to an increased democracy deficit and corruption, plus reduced knowledge of economic performance. Entrenched historical informality related to cultural factors, oppression and social exclusion may have led to strong self-regulation, making the informal economy resistant to BER meant to it.

**2. Which areas of the business environment require attention for reducing the informal economy?** The paper looks at nine strategy areas for encouraging formality for five sub-groups with varying degrees of informality. Among other

recommendations, the paper argues that BER *that* focuses on cost reduction is incomplete since (i) an owner's informality decision also includes an assessment of *benefits*, (ii) BER is incomplete since it tends to deliver one-size-fits-all cures, rather than having reforms differ by subgroup within the IE, (iii) ignorance often plays an important role in persistent informality among subsistence business and the weaker end of the unofficial enterprise spectrum. Given that compliance enforcement is weak for many in the informal sector, persuading informals to register their business activity requires there to be consistently available and reliable benefits from which they can profit in the short-run. Once these benefits are available for the targeted audience a communications program should be implemented to advertise their existence and to educate informals on their use; this imply training programs.

Yet, mere technical reforms inspired by cost/benefit analysis are unlikely to work if the underlying issues of empowerment are not addressed, especially when targeting subsistence activities and the weaker end of unofficial enterprises, which some analysts have written off as businesses "irrelevant" for BER. Hence, a crusade to register and bring into regulatory and fiscal compliance *all* informal businesses is unlikely to be cost-effective or even desirable, assuming it were feasible. The underlying institutions seeking the compliance of economic agents must first warrant their faith. Without warranting such faith, a "formalized" informal sector might be even less efficient and poorer. However, economically empowering those in the IE to increase their economic activity and take advantage of their varied assets to invest in income-generating activities may increase their economic stake in the system and lead them to incrementally—and voluntarily—increase their participation in the various dimensions of formality they deem necessary as they seek out ways protect their gains and expand their opportunities.

Reformers should also consider how to strengthen and raise the quality of customary and traditional governance methods at the same time as developing integration and convergence paths to the formal system. This does not mean deferring the process of providing all economically active members of society with a formal identity. It means that not only will a BER need to be tailored to target the subgroup of interest or the pillar of empowerment but it will also have to be packaged and promoted within the appropriate cultural context if it is to be successful. It also means that BER will need to consider how existing practices might provide a blueprint for the design of reforms, how the linkages between formal and informal structures can be strengthened to empower the poor, and how to grow a regulatory system over time (shifting from more to better-quality regulation and the right balance between security, supportive structures, and flexibility in both the formal and IE).

**3. Why do some businesses choose informality over formality?** There are roughly four degrees of enterprise informality. At one end are BoP subsistence

activities of mostly single individuals, be they farmers or street traders. Due to lack of skills, education, and disposable capital, informality may not be a discretionary choice of this subgroup, which may have little chance of “graduating” into a more productive and dynamic enterprises. At the other end are the well established, larger firms in the economy—including state-owned enterprises—with unreported sales, evaded taxes, undeclared workers, or part of operations hidden due to lapses in regulatory compliance. In short, a business can choose to be both formal *and* informal, with BER affecting elements of both decisions.

Between these two extremes is the rest of the IE, which comprises a mixed group of what has been called unofficial enterprises, and contain some of the potentially most dynamics firms of the IE. Here, the owners of the small manufacturers, service providers, and distributors of this group have a much higher levels of skills and education than those of the subsistence subgroup, though they still operate in labor-intensive and highly competitive local markets. A proportion of this subgroup may even be registered in some way. In the next level up are the small- and medium-scale enterprises (SMEs). While their owners are similar to the previous level their firms are often registered and tend to engage in more capital-intensive production and in markets with higher entry barriers.

The paper finds informality encouraged by seven categories of costs and nine categories of benefits. No single area leads an economic agent to remain informal. Rather, the characteristics of each group lead it to behaviors that select out of various aspects of formality. These include education/skills, capital intensity, financial requirements, product/service type, and market characteristics. These decision factors can also synergize, e.g., property rights bring increased economic benefits when linked to a functional credit system and market, but they do not, by themselves, cause the emergence of a functional and pro-poor credit system. Ignorance of the law and a perception that there were few benefits to formality so were more frequent for the subsistence poor (who often have no tax liability) while evasion of taxation and avoidance of regulatory predation were more important for small firms.

While the explanatory power of the cost-benefit approach is stronger the larger is the firm, its underlying the assumptions described in the text can limit its appropriateness for more modest economic agents. In the case of subsistence enterprises and informal wage workers, causes of informality include lack of education (especially business training), complex household structures, social norms, fear/lack of trust of government, and, above all, lack of economic and legal empowerment, in addition to existing formal BE constraints. Empowerment explanations focus on institutional failures that tend to make formality unreachable and, thus, informality involuntary. These include (i) lack of access to a well-functioning justice system, (ii) lack of effective property rights to tap the intrinsic economic power of their property, (iii) unsafe

working conditions for workers (and for women and children in particular) when their employers operate outside the formal legal system, and (iv) lack of market access (to credit, investment, and international and domestic markets) as their property and businesses are not legally recognized. The paper shows how these motivations combine depending on the geographic region.

**4. How should reforms be designed to address informality in firms that are rural, owned by women, or within specific sectors?** BERs to address informal business activities by women would include promulgating laws and statutes to create gender neutrality in ownership rights through joint titling, common property, and in equitable inheritance. Recognizing the inevitable gap between *de jure* and *de facto* law, the ILO believes implementation would be strengthened by establishing a compliance unit to constantly monitor gender issues and follow up on enforcement. The authority would be itself strengthened by the presence of effective women's associations. Some experts, however, worry that this would simply increase bureaucracy, though there are precedents: BER in some countries already establishes commissions to ensure compliance with competition regulation. An implication is that support for the formation and strengthening of women's associations should be considered as part of a BER package that aims to include the informal economy. In addition to technical assistance, competitively allocated grants to women's entrepreneur associations should also be considered. *However*, laws on gender neutrality (and other reforms in the paper, like formal court judgments of land disputes) may not be deemed legitimate if custom has them under the jurisdiction of tribal leaders.

The rural sector, with its greater geographic extent and lower population density, is subject to higher marketing and distribution costs and higher transaction costs of formality. Regulatory and fiscal compliance agencies tend to be far away and the rural sector's lower incomes mean that official fees are regressive. Likewise, access to public and private services—among the benefits of formality—is less available. Hence, incentives for the financial sector and increased budgets for the judicial agencies would need to be considered to better service this group if it is to decide that formality is worth it. BER should also consider creating rental markets for land and real property, since leasehold tenure can be insecure or there may be restrictions constraining land leasing. The idea is to facilitate renting so as to improve access to land by those remaining in the rural sector. Among the sector-specific actions to support street entrepreneurs, artisanal miners, and textile workers is to foster associations. Still, the paper shows that often local laws and regulatory enforcement on informals can run contrary to central government development (anti-poverty) and economic growth policies.

**5. What institutions are the most appropriate program partners?** Consider the donor's side first. Many of the changes that lead to sustained improvements

require incremental reforms since they operate close to the cultural level. This requires donor initiatives to have a long-term perspective and strategy. Some donors are better at this than others. Some countries and donors are experimenting with multi-donor-financed development funds in this regard. Still, in spite of the Paris Declaration on Aid Effectiveness, each donor's program process, pipelines, and budgeting, are on different cycles (and with different constituencies), making it hard for all but the shortest collaborations to work well. Finally, it is important to note that the totality of donor funds worldwide is simply insufficient to pay for all the BERs in all the countries that need them. Hence, donors should fund "demonstration" reforms from which other countries can learn and choose from.

On the recipient's side donors need to design BER interventions to better align donor objectives with the incentives their projects create for the host-country and its public and NGO recipient institutions. To ensure that in the long term BER includes the interests of the IE the paper recommends creating and supporting civil society organizations representing various beneficiary groups which then have the opportunity to participate in advocacy and public regulatory proceedings. This strategy empowers the constituencies who "win" from the reforms to provide the government's reformers with political cover as well as the valuable ground-level information for success. These groups can also be among the donor's partners for monitoring the implementation of BER. The paper raises challenges facing donors of civil society partners, such as sustainable financing.

**6. Does BER focused on informality impact economic growth and poverty reduction?** The paper finds no simple relationship between working informally and being poor, and working formally and escaping poverty. While richer countries tend to have smaller informal economies than poorer ones, we find little evidence to suggest that economic *growth* in a country *per se* will cause its informal economy to shrink. This is because the cause of the informal economy is not the level of economic activity but the quality of the country's fiscal, regulatory, and social institutions, as well as its public services. Thus, while BER influences these latter areas and, therefore, the size of the informal economy, its effect on economic growth through formalization may only be in the long term. What is striking is that most BERs that influence the formality decision are the same reforms recommended by the labor empowerment literature to alleviate poverty in the long run.

**7. How can a donor support informality-reducing business environment reforms?** Donors should support not just reforms that create a more legitimate and fair result but also support a participatory process of designing and implementing reform that is perceived as legitimate. This also increases the beneficiary's stake in the results which strengthens sustainability. They should also promote incremental change while encouraging the process to continue toward

the long-term goals. This is especially the case with reforms whose *de facto* implementation requires significant cultural or political evolution. For example, it is key to change the mentality of officials on the role of informality in the country's development and on themselves as facilitators of business opportunities for all, not just as policemen. Thus, donors should support creation of a strategic communications plan that would provide the overarching framework to guide the development of region- and even demographically specific public information campaigns. These campaigns would have the objectives of strengthening the legitimacy of reform efforts, encouraging public (civil society) participation, and on teaching civic responsibilities.

Donors should consider supporting complementary policies to increase BER effectiveness. The paper places special emphasis on (i) reforms to increase legal and economic empowerment (including greater availability to low-cost alternative mediation and dispute resolution); (ii) greater investment in primary and secondary education and vocational training, as well as the legal empowerment of women; (iii) expansion of low-cost health clinics and more inclusive approaches to social protection and social security (delinked from the employment relationship). While these reform efforts have been considered the domain of poverty alleviation policy, the paper argues that such reforms can also improve the BE for informal business. Analogous arguments hold for (i) decentralization and devolution; (ii) civil service reform; and (iii) executive branch rationalization.

## Outstanding Issues and Opportunities

Areas of BE meriting further attention include various tests of policy effectiveness (especially on the subgroup that experience suggests has no chance of “graduating” to more sustainable, formal enterprises without such additional policies); actions and studies related to gender and rural aspects of the IE; the implications of the short and medium run BER that directly leads to economic growth are not always the same as those that directly alleviate poverty; and the further scope for actions that donors might take to support BER-oriented development strategies. Also at issue is the strategy of building upon indigenous customary and traditional methods of governance (appropriately strengthened with donor assistance) as an intermediate adaptive step for the BoP to converge to full formality. This approach is not without its dangers since these original methods of governance did not evolve to promote impersonal exchange, the motor of modern markets. Another complication here is that policies empowering the poor run from passive to proactive. For example, it is one thing to oblige a government to provide a legally acceptable free identity registration or a land cadastre, but quite another for it to guarantee access to housing, to

provide unemployment insurance or social security, to enforce a minimum income, or to offer free health care.

These issues point to opportunities for further policy analysis, project redesign, or field pilots. These include designing BERs (i) not just to address *areas* of informality but also to target subgroups of informality; and (ii) to influence the informality decision by expanding the benefits side—including elements in support of social protection. Moreover, since donors cannot possibly pay for all the BER still required by developing countries, donors should engage in greater experimentation, especially with regard to the class of emerging incentive mechanisms based on public disclosure. The paper describes several. Based on inter-jurisdictional competition, one uses *Doing-Business*-like indicators applied to the sub-national government (SNG) level to encourage a “race to the top” competition among jurisdictions to implement *de jure* BER. A second relates to collaborations between “base-of-the-economic-pyramid” IE businesses and an (often foreign) formal firm, designed to align the incentives of formal firms seeking profits with those of the recipient community seeking socio-economic benefits.

Given the limited quantitative evidence by informality subgroup on the relative weaknesses in areas of the BE that inhibit formalization, it is important to collect and analyze more survey data across countries by subgroup, gender, and location. The DCED should consider developing a survey instrument to assess the importance of the cost *and* benefit sides of the formality decision of each sub group. Furthermore, given the knowledge gaps on addressing informality and the need for greater innovation in tackling it, donors should rigorously evaluate their BER activities aimed at reducing informality. Adding only 5 to 10 percent to the project cost, such evaluation not only helps a government avoid mistakes and donors to replicate successes, but it offers a chance to identify negative as well as positive lessons. The DCED should consider (i) developing donor guidelines on when a project may be exempted from rigorous M&E, (ii) recommending member agencies to use staff incentives to encourage their project designers to take advantage of newly available methodologies, and (iii) funding the writing of a manual to advise BER project designers on what project evaluation techniques are most suitable by type of BER.





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# 1

## Introduction

Great strides have been made over the last decade in developing countries to clarify, simplify, and make more predictable the legal and regulatory environment within which business operates, on the one hand, and to strengthen the institutions required to protect property rights, including contracts, on the other. Yet in some respects business environment reform (BER) still faces several unresolved challenges. Principal among these relate to the apparent reluctance of the majority of businesses—usually those that are micro and small—to “formalize,” which, roughly, requires becoming officially registered as a business and/or as a taxpayer. By remaining informal, a firm is unable to take full advantage of the legal, financial, and marketing benefits that, in principle, the judicial, banking, and economic systems of its country offer. This holds back a significant share of the population—perhaps as many as 4 billion people—from attaining its economic potential and, as a result, may leave a large market, whose value some observers place at \$4 trillion, untapped.<sup>1</sup> Worse, this situation perpetuates the poverty and lack of dignity of those living at the “base of the economic pyramid” (BoP), thereby exacerbating socio-economic inequality and, through its impact on youth unemployment, perhaps generating terrorist recruits.<sup>2</sup>

“The implications of widespread informality for developing countries appear extremely serious: lost tax revenue limits the scope of the state to provide services, and increases dependence on aid. If a high proportion of business activity operates

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<sup>1</sup> Estimates come from Hammond et al. (2007). To this one could add that more than 1 billion people struggle to survive on less than \$1 a day (UN 2005), for which roughly half—550 million—are working (ILO 2005).

<sup>2</sup> According to London (2007; 11), “[t]he base of the pyramid is a term that represents the poor at the base of the global socio-economic ladder, who primarily transact in an informal market economy.” On the link to terrorism see Dhillon (2008).

outside the scope of regulation and policy interventions, governments are unable to shape macro-economic outcomes through policy. The need to stay ‘under the radar’ restricts the potential for firms to grow, while the absence of predictable, enforceable rules increases risks, and corruption. Finally, the absence of a ‘fiscal-social contract’ between the state, business and citizen, represented by the exchange of regulatory compliance and tax on the one for hand, for services and the rule of law on the other, undermines democracy and the emergence of effective states.”<sup>3</sup>

Though this amorphous group of firms has been given as many names as its firms have motivations for their actions, this paper follows the convention of the Donor Committee for Enterprise Development (DCED) by referring to transactions outside the formal economy as being in the *informal economy* (IE), regardless of motives.<sup>4</sup> To appreciate just how large a challenge the IE is for BER, one need only consider its prevalence. Depending on the country, the IE can reach 70 percent of official GDP and in some it has surpassed 50 percent of total economic activity.<sup>5</sup> Calculations put the value of the global shadow economy at US\$9 trillion.<sup>6</sup> The ILO (2000) found that the share of informal non-agricultural workers in work force was 65 percent in Asia and 51 percent in Latin America (LAC), 78 percent in Sub-Saharan Africa (exc. South Africa), and 48 percent in North Africa. Finally and most frustrating, in spite of all the innovative and extensive BER carried out to date, the size of the IE is actually *growing* (with the exception of in the CEE, where the rate of increase is falling).<sup>7</sup>

Due to its large size, the IE exhibits significant regional variation. In *Sub-Saharan Africa* (SSA), where job creation needs to exceed 5 percent just to keep up with high fertility, a job, an enterprise, and a household are often the same thing. For 80 percent of the population unemployment is not a coping strategy, since survival is at stake. Here a profound lack of skills, credit, and infrastructure is probably more the problem than weaknesses in the business environment (BE). In *Latin America and the Caribbean*, while the poorest countries in this region have a similar story to that of Africa, there are many with rising incomes. For these, informals need title to assets, especially land, to be able to acquire financing for commercial activities.<sup>8</sup> For the newly industrialized countries of this region, the “[informal economy is more like] an unregulated entrepreneurial sector that behaves like small firms sectors

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<sup>3</sup> Richard Sandall, personal communication, June 2009.

<sup>4</sup> See, for example, DCED (2008). The OECD refers to this group as the unobserved economy while most economists typically split this group into three: the informal sector for subsistence activities, the shadow economy for enterprises that through premeditated evasion or fraud conduct some or all of their business outside the reach of the tax man or regulatory authorities, and the black market for activities that are *per se* illegal.

<sup>5</sup> The first figure is from Schneider and Enste (2005) and the second from Eilat and Zinnes (2002).

<sup>6</sup> *The Economist* (1999). This figure includes then existing activity, whereas the figure in the previous paragraph refers to what still remains untapped.

<sup>7</sup> See Loayza and Rigolini (2006) as well as Schneider and Klinglmair (2004).

<sup>8</sup> De Soto (1989).

everywhere, [rather] than one comprised of involuntary, disadvantaged, precarious, or underpaid workers.”<sup>9</sup> Here, the IE is often the main entry point of young uneducated workers into a paid job; “[t]hese are mostly young workers not yet tracked into regular employment”, having average tenure of two years before moving on.<sup>10</sup> It also absorbs those seeking part-time work, such as mothers with young children and retirees. One study found that “small entrepreneurs train more apprentices than formal education system and government schemes together”.<sup>11</sup> *Asia* displays greater variation than SSA, with the Indian Subcontinent, Southeast Asia, and China each having their own idiosyncrasies. Informality is more institutionalized than in SSA and the poor work environment for informal children and women especially problematic (including as informal wage labor) in South Asia.<sup>12</sup> Education is still a major problem. Yet, the strong extended family networks often dampen social costs of informality and the region also boasts lower transaction (indirect) business costs than in other developing countries. In the *transition economies* (TRES) of Central and Eastern Europe and the Former Soviet Union, the informal economy is mainly about avoiding taxation, regulation, and corruption. In fact, the term “informal” is a misnomer since formal state and private enterprises are main contributors (quasi-formality). Household participation in the IE is more about self-employment to supplement formal employment: small gardens, transport services, consulting.

The purpose of this paper is to provide guiding principles and advice to donor and development agencies, and their program partners, on how BER programs might further contribute to poverty alleviation by reducing informality and encouraging informal business to start operating formally.<sup>13</sup> While BER may not be the only or even main policy tool to address the concerns related to the IE, it is still important that BER could do more to address the needs of the BoP. As such, the paper focuses on identifying the links and analyzing the impact of BER on the IE as well as how the IE impinges on the effectiveness of BER. The paper considers ways in which donor-supported programs can encourage the creation of incentives that lead informal businesses to formalize, and the impact on poverty reduction and economic growth from doing so.<sup>14</sup> The goal is to go beyond issues such as business registration and licensing to consider the full range of informal business practices that contribute to the IE, such as informal employment, trade, premises, and the failure to pay tax.

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<sup>9</sup> Maloney (2003, p. 2).

<sup>10</sup> Maloney (2003, p. 3).

<sup>11</sup> Hemmer and Mannel (1989).

<sup>12</sup> Sida study (Becker 2004).

<sup>13</sup> This paper summarizes the findings of a more comprehensive eponymous report (Zinnes 2009a) commissioned by the DCED.

<sup>14</sup> Of particular concern is avoiding policies that increase formalization but concomitantly are likely to increase poverty. For example, rather than making the benefits to formality more attractive, more accessible, or better understood to the firm, governments might attempt to force informal firms to register through fines or other coercive methods when the transaction costs of registering plus the fiscal and regulatory obligations of being formal might outweigh the economic benefits to the business.

Finally, in addition to providing recommendations, the paper both provides a framework for thinking about how the BE and IE interact as well as identifies related policy issues and opportunities outstanding.

*Defining the business environment.* According to DCED, “the business environment [is the] complex of policy, legal, institutional, and regulatory conditions that govern business activities.”<sup>15</sup> For the DCED the business environment forms part of the investment climate, which includes [those] administration and enforcement mechanisms established to implement government policy ... that influence the way key actors operate.”<sup>16</sup> Hence, it includes broader factors of private sector growth such as infrastructure and access to finance.

Depending on the issue and the type of political system, reform may be carried out at the regional (multi-country), national, sub-national, or sectoral levels, though some reforms require work at multiple levels. Trade and investment liberalization and harmonization are generally attacked at the regional level and through regional organizations. National-level reforms focus on competition, business (starting, operating, and bankruptcy) and labor regulation, tax policy, and trade promotion. Sub-national-level reforms may consist of addressing local registration and licensing procedures, regulations, and private sector development policies and initiatives. Finally, sector-level reform deals with improving sector-specific licensing, permitting, regulations, and promotion. These reforms may address errors of omission (adding a service or regulation that has been lacking) as well as commission (removing a regulation that has been onerous or unnecessary).

*Defining the scope.* This paper takes the goal of BER to be economic growth and gender-neutral poverty reduction and not formalization, though the latter is hypothesized to contribute to both of the former. The units of interest should include informal small and micro businesses—subsistence (“survivalist”) activities as well as those with significant growth potential, medium and larger firms that operate formally (for their health might be aided or abetted by the smaller informal firms), and those larger firms that may appear formal but engage in systematic underreporting or informal (or sometimes corrupt) agreements and relationships to prosper.

This paper also considers that the causal linkages between BE and the IE run in both directions: the nature of the BE affects the size, distribution, and characteristics of the IE while the latter influences the effectiveness of BER. Finally, it is useful to distinguish between, first, the impact of the BE on informality at a moment in time, and second, the more dynamic impact of BER. The report deals with these concerns (i) by presenting an up-to-date understanding of how the *level* of quality of the BE influences the formality decision and then (ii) by examining how *reform* itself

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<sup>15</sup> DCED (2008, p. 2).

<sup>16</sup> *Ibid.*

impacts the character of the IE. The paper then indicates how the presence of an IE can influence the effectiveness of BER as well as lead to unintended consequences.

*Caveats and challenges.* Clearly, addressing all these issues and nuances, not to mention potentially contradictory policy objectives, is a tall order. Further complexity lies in the regional variations in the scale and nature of informality, while the premeditated efforts of informal business to avoid detection are an extra challenge to research and understanding in this field. Finally, the topic also involves many multidisciplinary issues as one delves into the cultural, historical, and institutional aspects of developing and transition countries.

This paper does not carry out any original data collection or empirical analysis. Rather, the paper relies on the extremely rich existing literatures on BE and on the IE, as well as on discussions and meetings with members of the donor community, to highlight and examine policy questions of direct relevance to them. At the same time, the unabridged report was not meant to be a survey of the literature since other papers already do this.<sup>17</sup> Likewise, it is not possible for a single report, not to mention its summary discussion paper, both to develop lessons for donors and simultaneously to provide a meaningful description of the operational specifics of the applications in each of the reform areas. Instead, the report (and this paper) restricts itself to examining how and where BER can address the root causes of the different types of informality and what *other complementary* policies may be necessary to do so most effectively. The paper argues that the uneven successes of BER efforts to date are not due to fundamental mistakes or errors in those efforts, but are consequences of larger economic development challenges contributing to a growing BoP. This different emphasis leads to a call for greater attention to economic empowerment.

*Layout of paper.* The paper proceeds by first summarizing the various dimensions of the framework of analysis in Section 2. Using this framework, in Section 3 the paper presents the main findings and recommendations of the unabridged report by specifically addressing seven policy questions posed by the DCED. Finally, based on an assessment of both the insights as well as the limitations of these findings, Section 4 lays out a series of opportunities for innovation in future donor BER applications.

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<sup>17</sup> See Gerxhani (2003), White (2004), USAID (2005).



## Framing the Issues

Clearly the first step in framing the issues is to provide a more precise definition of what it means to be part of the IE. Is it just not having a business registration? Does it mean engaging in transactions which evade tax obligations? Or does it mean not being in full regulatory compliance? To confuse matters there is a spectrum for each of these and these characteristics can be combined. For example, does the IE include large registered state and private enterprises that underpay taxes due to mismanagement or fraud? Does it refer to subsistence workers who have no tax obligations or requirement to register but who are hired by larger firms that evade payroll taxes? At the lower end of the scale, does the IE include undeclared wage and subcontracted workers or just self-employed business, commercial household production, and micro-enterprises? From the DCED's perspective, the short answer is any of the above.

Adopting this broad and all-inclusive definition for the IE has a plus side and a minus side. From the plus side, “[m]ost people, entrepreneurs, and firms in the informal sector do interact with public institutions to some extent; hence it is more appropriate to see informal activity as a continuum of compliance, rather than in a dichotomous manner.”<sup>1</sup> On the minus side, it runs the risk of finding analysis and recommendations from the literature confused and even contradictory. This risk can be minimized by disaggregating the IE according to two classifications, one for the businesses themselves and the other for their activities. This framework also facilitates determining operationally the degree to which BER impacts each informality subgroup and activity to contribute to economic growth and poverty reduction.

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<sup>1</sup> Oviedo (2008).



## 2.1 Why Do Some Businesses Choose Informality Over Formality?

The literature finds evidence for roughly four notional degrees of enterprise informality, a convenient typology of which is provided in Table 2.1. At one end are the

**TABLE 2.1** A simplified typology of the degree of enterprise informality

Characteristic	Least dynamic		Highly dynamic	
	Completely informal		Partially formal	
	Informal economy			Formal economy
	Subsistence enterprises	Unofficial enterprises		
Mostly unregistered		Mostly registered	Official enterprises	
Degree of Informality	100 percent	High proportion of sales undeclared and workers not registered	Some proportion of sales undeclared and workers unregistered. May use outside the official purview (e.g., Internet to deliver software)	
Type of activity	Single street traders, cottage/micro enterprises, subsistence farmers	Small manufacturers, service providers, distributors, contractors	Small and medium manufacturers, service providers, software firms	
Technology	Labor intensive	Mostly labor intensive	Knowledge and capital intensive	
Owner profile	Poor, low education, low level of skills	Poor and non-poor, well educated, high level of skills	Non-poor, highly educated, sophisticated level of skills	
Markets	Low barriers to entry, highly competitive, high product homogeneity	Low barriers to entry, highly competitive, some product differentiation	Significant barriers to entry, established market/product niche	
Finance needs	Working capital	Working capital, some investment capital, supplier credit	Investment capital and working capital, letters of credit, supplier credit	
Other needs	Personal insurance, social protection	Personal and perhaps business insurance	Personal and business insurance, business development services	

Source: Adapted from Djankov *et al.* (2002; p. 4).

subsistence activities of mostly single individuals, be they farmers or street traders. They comprise the bulk of the BoP. The literature argues that due to a lack of skills, education, and disposable capital, members of this subgroup have little chance of “graduating” into a more productive and dynamic enterprises.<sup>2</sup> This raises the policy question, examined in later sections, of whether the subgroup should be ignored in formulating BER or, if not, what special provisions need to be made to existing BER policies and tools to assist this subgroup.

At the other end of the spectrum are the well established, larger firms in the economy. This subgroup may even include state-owned enterprises. This subgroup would appear to be quintessentially formal to the casual observer. However, an independent audit would reveal for enterprises in this subgroup that some sales are unreported, some percent of direct and indirect taxes are evaded, some workers are undeclared, or some part of operations are hidden due to significant lapses in regulatory compliance.

Between these two extremes is the rest of the IE, which comprises a mixed group of what has been called “unofficial enterprises.”<sup>3</sup> On the one hand, there are the “small manufacturers, service providers, distributors, and contractors.”<sup>4</sup> The owners of these enterprises have much higher levels of skills and education than the subsistence subgroup, though they still operate in labor-intensive and highly competitive local markets. In fact, some proportion of this subgroup may even be registered in some way. In the next level up are the small- and medium-scale enterprises (SMEs). While their owners are similar to the previous level, their firms are often registered and tend to engage in more capital-intensive production and in markets with higher entry barriers. These two “middle” subgroups of unofficial enterprises are found to contain some of the potentially most dynamic firms of the IE.

### 2.1.1 A cost-benefit approach to formality

The literature is rich with analysis and recommendations regarding how to design BER to address informality. To evaluate this literature in search of appropriately designed BER for each of these subgroups, a framework is developed based on two complementary approaches, cost-benefit analysis and legal empowerment. Their selection is based on the key insight that for a BER to be successful, it must address both each subgroup’s corresponding motivations for remaining informal as well as its needs to be economically productive. This insight has led many analysts to adopt a cost-benefit approach to understand each subgroup’s behavior.<sup>5</sup> Cost-benefit analysis views the formality decision of the business owner as

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<sup>2</sup> Djankov *et al.* (2002; p. 3)

<sup>3</sup> *Ibid.*

<sup>4</sup> *Ibid.*, p. 4.

<sup>5</sup> For examples of the large literature using this approach, see Maloney (2004), Oviedo (2008), and Eilat and Zinnes (2002). The DCED reaches a similar assessment in Ingram *et al.* (2007).

one of rational choice, where the transaction costs in terms of money, time, and knowledge required to register with official agencies and comply with regulatory and fiscal obligations are weighed against the benefits that formality might confer in terms of greater access to goods and services at their existing levels of quality and reliability.<sup>6</sup>

While this sounds straightforward enough, several subtleties need to be brought out to put what follows into perspective. First, the above decision calculus presupposes that there is an option of becoming formal, i.e., that the worker or business is not *excluded* (say, due to onerous regulations or to lack of opportunities) from formal activities but is voluntarily considering *exit*. Second, rational decision making is limited by the quality of information the agent has. Hence, for example, illiterate entrepreneurs, those who are literate but lack sufficient training (say, in accounting), and those operating in an environment in which the legal and regulatory options and requirements are either not advertised or learned only through hearsay, are potentially not going to make the best decisions (even ignoring whether their rationality is “computationally bounded”).<sup>7</sup> Third, it is not clear whether the right unit of decision making is the entrepreneur, the household, or even the extended family. In the BoP, risk-coping strategies take on a life-and-death importance. “[O]ften the choice between formal and informal employment depends on the household structure and the labor market status of other household members. The benefits and costs of work in the different sectors are viewed in [this] light...”<sup>8</sup> Likewise, the household’s life cycle can affect the cost-benefit tradeoff since “[a]s time goes by, the size, education and age composition of household members change and, along with it, labor market choices may change.”<sup>9</sup> Fourth, the decision to become formal or informal is really a subset of a larger number of choices. Beyond the decision to enter the labor market (or remain unemployed), there is the (potential) choice between wage work and self-employment. Embedded in each of these latter options is the formal-informal choice of which most of the literature focuses. To this complex of hierarchical decision making is the option of migration (e.g., to an urban area), immigration to work abroad, and, even to undergo further education (i.e., invest in one’s human capital).<sup>10</sup> Needless to say, the mechanics and quality of the decision making

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<sup>6</sup> The actual decision implicitly involves an examination of the present discounted expected value of both formality and informality, as well as the risks and uncertainty attached to cost and benefit streams. The unabridged report provides both a mathematical and comparative statics graphical treatment of these decisions.

<sup>7</sup> Thanks to M'Hamed Cherif in his comments on an earlier draft for noting that this point was missing.

<sup>8</sup> Jütting *et al.* (2008; 28).

<sup>9</sup> *Ibid.*

<sup>10</sup> Unfortunately, from a BER policy perspective, one must also entertain the possibility that even a perfectly informed and rational economic agent may not make the socially optimal decision (Jütting *et al.* 2008). This may be due, *inter alia*, to missing markets and a short-term horizon.

process have no bearing on whether the regulatory framework or the benefits to formality meet the needs (demands) of those in the BoP contemplating their choices—a point returned to below.<sup>11</sup>

Table 2.2 lists the principal motivational categories of costs and benefits of becoming formal for the four subgroups of businesses introduced above. As is seen, while important (since they are up front) time and financial costs of complying with start-up procedures is only one of several sources of costs for a new or existing business owner. Depending on the size and sector of the business, other explicit cost categories include tax obligations (direct, such as taxes on profits and payroll; indirect, such as sales, turnover, value added), labor regulations (e.g., minimum wages, cost of hiring, including mandated benefits, restrictions on firing/severance, and occupational safety protections), production regulations (e.g., environmental), and product regulations and standards (e.g., food quality). An additional complexity raising costs is that on top of the administrative demands of central government ministries, sub-national governments (SNGs) also often require operating and construction permits and other often-sector-specific licensing, often leading to overlapping remits and jurisdictions between different levels of government. Most of these cost categories impose fixed costs on a business and therefore are regressive; they are more burdensome the smaller the firm. On the other hand, subsistence businesses tend to be below the radar screen of inspectors and collectors so that, again, it is the more dynamic unofficial informal enterprises that will incur these costs.

There are other less quantifiable sources of potential costs, including fear of predation by corrupt tax and regulatory inspectors. Likewise, many business persons harbor a visceral distrust of government, no doubt based on justifiable past experience. Beyond these are motivations on the two extremes of the informality spectrum. At the subsistence end, micro-enterprises may simply be ignorant of the legal requirements for doing business; at the formal end, weak management may result in theft or fraud by employees.<sup>12</sup> Finally, the owners must consider the potential cost of exiting the formal sector. Unfortunately, since owners are unlikely to have any experience in exiting the formal sector, they may either overlook these potential costs or artificially inflate them due to the uncertainty surrounding their size.

On the benefits side, in addition to avoiding the threat of enforcement penalties, some of which are addressed by BER, the benefits of being formal fall into the categories of access to credit, security of property rights, access to markets, and availability

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<sup>11</sup> Thanks to M'Hamed Cherif urging that this point be made more explicit.

<sup>12</sup> Of course, larger firms can engage in "transfer pricing" with their subsidiaries or suppliers, a form of tax evasion.

**TABLE 2.2** Indicative motivations for transacting in the informal economy

Motivation	Informal economy <sup>(a)</sup>			Formal Official enterprises
	Subsistence enterprises	Unofficial enterprises		
		Mostly unregistered	Mostly registered	
<b>Costs</b>				
Tax evasion: Direct		√	√	√
Indirect		√	√	√
Labor regulation			√	√
Other regulation				√
Fear of predation		√	√	
Fraud				√
Distrust of government		√		
Costly start-up procedures	√	√	√	
Ignorance	√	√		
<b>Benefits</b>				
Bank finance			√	√
Non-bank financial services			√	√
Land tenure	√	√	√	
Government/ donor TA			√	√
Public utilities	√	√	√	√
Social protection services	√	√		
Court/police access			√	√
Avoid compliance fines			√	√
Market opportunities			√	√

<sup>(a)</sup> See Table 2.1 for a description of each subgroup. Column headings adapted from Djankov *et al.* (2002; p. 4).

of social protection.<sup>13</sup> Access to bank financing and government-sponsored credit initiatives typically require being registered and having filed tax returns. Becoming formal, therefore, may increase access to credit *if* the terms of lending are attractive. This is a big “if” because in many developing countries collateral requirements deter micro and small firms found in the unofficial enterprise subgroups from applying for loans. Finally, bank financing and even government initiatives are rarely designed for subsistence businesses, which instead rely on family and friends or, microfinance where available.

Being formal can increase both tangible and intangible property rights. *Tangible* property rights include security and protection of land tenure. Without these, small firms cannot obtain mortgage-backed bank credit as well as public utility access; larger formal investors will simply exit since they won't operate with unsecured property rights. *Intangible* property rights refer to the protection of contracts and constitutional rights, which require the institutions of dispute resolution and commercial court-adjudicated contract enforcement. While subsistence businesses tend to rely on traditional and customary mechanisms of justice, through the work of de Soto and others it has been found that land tenure and possession of legally recognized identification is extremely important for the welfare of this group. For the unofficial enterprises the degree protection of property rights is a benefit in their decision to become formal depends on the existence, efficiency, predictability, and objectivity of the judicial institutions.

The social safety net benefits of formalizing will depend on their structure in the particular country.<sup>14</sup> In some countries, safety nets are not tied to formal jobs; in others, some sectors have access to insurance. In many cases, once one member

<sup>13</sup> At first it would appear that the “informal sector serves a very robust domestic market and rarely [has] problems sourcing products from the formal sector for local sale” (Mavis Owusu-Gyamfi, private communication, June 2009). This may be true for such segments as traders and hawkers and even some agricultural business at the local level. It also can be true for some SMEs, depending on the sector and country. However, there is a large literature documenting the lack of market access (i) to those seeking formal wage employment (Becker 2004), (ii) for women in general—Chen *et al.* (2003; 35) lament that “the working poor, especially women, tend to face a wide range of constraints in running their micro-businesses[, including]... lack of market access and participation...”) , (iii) to property markets (de Soto 1989), and (iv) to informals attempting to engage in production activities incrementally higher up the value chain, to expand and achieve economies of scale, or to avoid exploitative middlemen in the distribution chain (Gerxhani 2003; Oviedo *et al.* 2008; Prahallad *et al.* 2002; London 2007). One of the “pillars of legal empowerment of the poor” specified by the CLEP, for example, is “access to economic opportunities (e.g., ... international and domestic markets)” (CLEP 2008a; p. 5). Among the reasons for lack of access include (i) lack of education, skills, and literacy, (ii) registration requirements in regulations, (iii) distance to official sources information and the unavailability and cost of market data limiting access to market information (Djankov 2002) as well as preventing conformity with standards and regulations required for formal markets, and (iv) rigidities and anti-competitive market structures (especially in distribution).

<sup>14</sup> Among the main benefit components are health (especially pre-natal care), pensions, and unemployment insurance). Child care, while important for women's economic empowerment (see below) is rare in the developing world. For a discussion of pension policy options for informals, see Hu and Stewart (2009).

of the household has such benefits, it reduces the attraction of formality for the rest of the economically active household members. While not part of the social safety net *per se*, labor protection (e.g., occupational safety and health) is a type of social protection that is in greater evidence in formal firms. Such protection would be perceived as a benefit of being a formal worker relative to an informal worker; for the firm, however, it is an additional cost of formality (though it might attract higher qualified workers). Other benefits to formal workers typically include severance pay, a minimum wage, the right to union representation, and annual (and sometimes maternity/paternity) leave. Finally, it is interesting to note that a formality *cost* to one firm (e.g., requirements for social protection) can be a formality *benefit* to the firms or workers with which it does business.

The conventional wisdom is that an additional benefit for formal workers is that they receive more vocational training than informal workers (implying *ceteris paribus* that informal workers are less productive).<sup>15</sup> However, some argue that at least for middle income countries in South America more training occurs in the IE than through formal education programs.<sup>16</sup> Firms also receive “training” through business development services (BDS). For BDS provided by donor funding through a host government, these normally require the recipient firm to be formal, which thereby excludes many dynamic unofficial enterprises. Such exclusion is not always the case for micro-enterprises, for which donors often have specific programs.

Finally, the enterprise owner’s cost-benefit decision to become formal is completely different from the government’s policy question of whether there are net costs to the country of having an IE. For example, an owner is not concerned with degree of innovation or the weakening of macroeconomic management that having a large IE leads to, while the government would be.

With their motivations firmly couched within a cost-benefit framework, we can determine the degree to which BER can influence the idiosyncratic formality decision of each IE subgroup, on the one hand, and what modifications or complementary policies would improve BER effectiveness, on the other hand.

### **2.1.2 The empowerment dimension of formality**

The second key lens through which to craft effective BER—especially for the weaker end of the unofficial enterprises—and a source of complementary policies to increase BER effectiveness is that of economic and legal empowerment.<sup>17</sup> This perspective ties the causes of informality—the components of the cost-benefit decision—to the degree a nation respects certain human rights related to labor

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<sup>15</sup> Palmade (2005).

<sup>16</sup> Hemmer and Mannel (1989).

<sup>17</sup> See CLEP (2008) for a detailed introduction to the subject of empowerment.

and business.<sup>18</sup> On the labor side these rights relate to access to justice, security of property rights, the fulfillment of labor rights (as specified in the *Declaration on Fundamental Principles and Rights at Work* and, more broadly, in the *Decent Work Agenda*).<sup>19</sup> On the business side these rights relate to access to finance, limited liability, insurance, ability to use formal contracts, etc. Together these principles and rights promote a stake in democracy and, through public participation, a hand in ultimately shaping BE itself.<sup>20</sup>

These rights can be classified into four “pillars of legal empowerment of the poor”:<sup>21</sup> (i) lack of access to a well-functioning justice system, (ii) lack of effective property rights to tap the intrinsic economic power of their property, (iii) unsafe working conditions for workers (and for women and children in particular) when their employers operate outside the formal legal system, and (iv) lack of access to economic opportunities (e.g., credit, investment, international and domestic markets) as their property and businesses are not legally recognized.<sup>22</sup> Absence of these rights creates impediments to empowerment of the poor which result from their being informal.

While the cost-benefit analysis approach emphasizes the *voluntary* nature of the IE, the empowerment dimension emphasizes the more *involuntary* nature by placing more of the cause of informality on government failure (thereby leading to market failure). These are not contradictory views. Rather, it serves to underscore the central role of government as the source of both the costs and benefits of formality. Indeed, in a fundamental sense the ‘state’ and ‘formality’ are the same thing: both can be described as the *explicit* rules and institutions that society agrees on.<sup>23</sup> As will be seen, viewing the IE as in part a consequence of lack of economic and legal empowerment opens up new vistas for BER, though at the price of additional complexity and raising thorny policy questions. In particular, a focus on empowerment helps to identify additional policy instruments that are especially effective when targeting subsistence activities and the weaker end of unofficial enterprises, which some analysts have written off as businesses “irrelevant” for BER.<sup>24</sup> This paper argues, however, that mere technical reforms inspired by cost/benefit analysis are unlikely to work if the underlying issues of empowerment are not addressed.<sup>25</sup>

<sup>18</sup> While one might argue that rights by definition imply that empowerment issues only pertain to the benefits side of the cost-benefit decision, note that obtaining many of these benefits require incurring transaction costs, which historically has been the focus of BER.

<sup>19</sup> See ILO (2002) on *Decent Work Agenda*.

<sup>20</sup> Richard Sandall (personal communication, June 2009).

<sup>21</sup> CLEP (2008a; p. 5).

<sup>22</sup> This list is drawn from the foreword in CLEP (2008a).

<sup>23</sup> Richard Sandall (personal communication, June 2009).

<sup>24</sup> See Kenyon (2009, forthcoming). Still, regardless whether there are additional policy instruments available that are effective in targeting subsistence activities and the weaker end of unofficial enterprises, this does not mean that a priority-driven government of limited capacity should necessarily pursue them.

<sup>25</sup> Moore and Schmitz (2008) suggest that even this is not sufficient: the implicit political relationships between groups need to be identified and addressed.



The complication here is that policies empowering the poor cover the spectrum from passive to proactive. For example, it is one thing to oblige a government to provide a legally acceptable free identity registration or a land cadastre, but quite another for it to guarantee access to housing, to provide unemployment insurance or social security, to enforce a minimum income, or to offer free health care. Hence, BER designers are faced with the policy question of what the appropriate level of human rights (or alternatively public services) a government should provide for a given level of development. Still, regardless of the degree to which either BER should incorporate empowerment policies or a government should pursue more proactive empowerment, there is little doubt that complementary policies to support BER should include those related to legal and economic empowerment. Proposals on how this might be done are suggested in Section 2.2.2.

### **2.1.3 Initial conditions and the rules of the game**

A business person's evaluation of the costs and benefits of informality by necessity involves a comparison of the alternatives. These generally include traditional and customary practices. Likewise, owner behavior is closely influenced by perceptions of the legitimacy or fairness of government policy and law. Hence, this dual approach leads us to recognize that the incentives underlying the informality decision have their roots in history and culture, and often operate through their effects on legitimacy and trust. In other words, informality is a context-specific phenomenon, and one often modulated by state-business relations. These aspects are what economists refer to as the institutional dimension of development and include the study of the "rules of the game". For example, laws on gender neutrality or formal court judgments of land disputes may not be deemed legitimate if custom has them under the jurisdiction of tribal leaders.

These observations carry significant implications. It means that not only will a BER need to be tailored to target the subgroup of interest or the pillar of empowerment, but it will also have to be packaged and promoted within the appropriate cultural context if it is to be successful. It also means that BER will need to consider how existing practices might provide a blueprint for the design of reforms and how the linkages between formal and informal structures can be strengthened to empower the poor. There is a range of BER strategies that target not just the formal legal system, but also spontaneous ordering mechanisms and informal faith-based and customary practices.

These insights carry dynamic implications as well. Such BER would not always seek to modernize a service or regulatory system component in one step. Rather, since acceptance (and, therefore, use) of the "improved" system takes time for beneficiaries to experience and adopt it, some BER must take on an evolutionary perspective and one where education campaigns that promote its evolution take a prominent role. This may also grate against some prevailing ideologies, e.g., as in

“a shift of focus from regulation-versus-deregulation to [a] focus on the quality of regulation, and determining the right balance between security, supportive structures, and flexibility in both the formal and IE.”<sup>26</sup>

Finally, the literature finds that initial conditions lead to significant regional diversity in the extent and characteristic of the IE, as cited in the opening paragraph of this brief. Estimates suggest that from 1990 to 2003, there have also been regional differences in the IE’s share of GDP, which has grown in Sub-Saharan Africa (from 30 to 39 percent), South Asia (from 22 to 28 percent), in LAC (from 29 to 38 percent), in the Middle East and North Africa (from 21 to 31 percent), in East Asia and the Pacific (from 18.5 to 20 percent), and in the TREs (from 33 to 37 percent).<sup>27</sup> Regional differences also extend to gender. Consider examples from three continents: in Chile (1997) the proportion of working men (women) engaged in the IE was, respectively, 32 (27) percent, in Côte d’Ivoire (1996) it was 37 (73) percent, and in the Philippines (1995) it was 16 (19) percent.<sup>28</sup> (It is not the case for all countries, however, that women form a larger part of the shadow than men.) Equally importantly, the literature indicates that regions have a different mix of the subgroups contained in Table 2.1. For example, Sub-Saharan Africa has a significant contingent of non-dynamic, involuntary, subsistence businesses while in the larger countries of Latin America, unofficial enterprises and skilled part-time workers tend to be voluntary and even oscillate in and out of formality.<sup>29</sup>

#### 2.1.4 Further considerations

While the outcome on whether to remain/become informal depends primarily on the enterprise’s cost-benefit decision, there are still several nuances to note. These draw on the discussions of empowerment and initial conditions.

*Is formality simply too costly for some?* Much BER appears to be focused in the first instance on reducing costs—costs due to onerous labor laws, weak tax administration, and inappropriate and inconsistently applied regulation. This *modus operandi* is incomplete for at least three reasons. First, an owner’s cost-benefit analysis also includes an assessment of *benefits*—which are often not particularly attractive—and are generally given insufficient attention by BER. For example, if the banking system does not lend to small enterprises, the judicial system is slow and unpredictable, and municipal services erratic at best, then the benefits of business registration are dubious at best. (Note that with low-level benefits BER needs to reduce the costs of formality even further—perhaps below the optimum level—to convince businesses to become formal.) Second, even within its focus on costs, BER is incomplete since

<sup>26</sup> CLEP (2008a; p. 60).

<sup>27</sup> Schneider (2004) and the World Bank (2005).

<sup>28</sup> Fox *et al.* (2006).

<sup>29</sup> See, for example, Maloney (2004).

it tends to deliver one-size-fits-all cures. As is argued above, however, to support the pillars of empowerment, legal requirements (and how government agencies implement them) should differ by subgroup within the IE. Examples here would be tax rates and thresholds, regulatory requirements, and registration procedures. Third, ignorance can play an important role in persistent informality among subsistence business and the weaker end of the unofficial enterprise spectrum.<sup>30</sup> Question 3.1 proposes options to strengthen each of these weaknesses in BER.

*Why are a higher proportion of small firms informal?* In terms of the *number* of firms, the evidence suggests that small firms are more likely to operate in the IE than larger firms.<sup>31</sup> On the one hand, such firms tend to benefit least from civic participation because of the limited nature of their dealings with the public and hired employees. On the other hand, the small expected lifetime tax contribution of such firms may not warrant a strong enumeration or enforcement effort on the part of the government. Asea (1996) suggests that these points mean that, for such firms, high taxation and high regulatory costs to formality may not be the most important determinant of the size and level of formality. Their limited investment needs make stable property rights unimportant and personal ties may be an adequate contracting technology. In this case, firms pay no taxes as a passive byproduct of their size. Regarding the judicial pillar, small firms are anchored in social networks, allowing implicit contract enforcement and insurance, given how expensive formal institutions are. It is only as firms grow that formal mechanisms become necessary.

*Is it voluntary?* A cost-benefit approach runs the danger of implying that informality is always voluntary. This may be true for formal enterprises, most SMEs, and workers in some regions. For example, in Mexico inflexible labor laws have been found to prevent worker and employer alike from entering into a formal contract that meets the needs of a worker who wishes to work part time (students, the old, women).<sup>32</sup> For subsistence businesses and some small firms the requisite knowledge and skills (and, perhaps, ethnicity) for accessing the formal system may simply be inadequate. In fact, for many subsistence businesses most of the benefits of formality as currently offered by BER are unattractive, while even the reformed procedures would be onerous. In many cases, they are doubly uneconomic: private compliance costs of becoming formal exceed their private benefits and social costs of becoming formal exceed social benefits once

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<sup>30</sup> Economic theory not only applies cost-benefit analysis to decision making but also to information search. Here it predicts that subsistence businesses, workers, and weaker unofficial enterprises might not expect the return to investigating formality options to be worth the effort. Of course subsistence actors may have been engaged in their activities for generations and not even realize such activities were now in need of registration or carried legal obligations.

<sup>31</sup> Levenson and Maloney (1996).

<sup>32</sup> Maloney (2004). On the positive side, in 2002 Mexico did address another aspect of informality by implementing the Fast-track Business Creation System to guarantee that micro and small firms could complete the registration process in two days. (Oviedo *et al.* 2008).

enforcement costs are included. Part of the problem is that many regulations are not sufficiently sensitive to the needs and capabilities of the various informality subgroups.

This discussion raises an important policy issue for BER. On the one hand, since there are many positive externalities to formality (or negative externalities to informality), economic theory predicts that private business will undervalue it, leading to levels of informality beyond what is socially “optimal.”<sup>33</sup> On the other hand, governments and donors face profound informational limitations when designing interventions, often leading to glaring differences between *de jure* and *de facto* implementation that can result in undesirable outcomes. For example, “changes in policy designed to reduce the extent of the informal sector may have negative effects on formal employment, average productivity, and wages.”<sup>34</sup>

These concerns have led some analysts to conclude that “policies to encourage formal sector participation are preferable to increased enforcement.”<sup>35</sup> Then as the BE improves, those in the IE (or at least the more dynamic ones) will feel empowered to increase their economic activity and take advantage of their varied assets to invest in income-generating activities, changing the nature of their business, and will increase their economic stake in the system. This, in turn, should lead them to incrementally—and voluntarily—increase their participation in the various dimensions of formality they deem necessary as they seek out ways to protect their gains and expand their opportunities. The result would be “aphasic formalization”.<sup>36</sup> In other words, for some (and perhaps all) subgroups of informal enterprises some aspects of formality should be made voluntary. Then, the successful impact of BER and its complementary policies could be “measured” by the degree to which enterprises reveal their preference for operating formally.

*Does informality have a principal cause?* The literature suggests it is a myth that one or other factor leads a business owner or worker to remain informal. Rather, it is a synergy of factors. For example, property rights bring increased economic benefits when linked to a functional credit system and market, but they do not, by themselves,

<sup>33</sup> See Section 3.3 for a discussion of optimal informality.

<sup>34</sup> Oviedo *et al.* (2008; 13). Consider some examples: (i) increasing labor inspections to encourage firms to hire workers formally rather than informally has been found to increase firm costs and thereby to reduce output and (formal) new hires (Almeida and Carneiro 2006); (ii) since the first workers a firm hires are on average those with the highest productivity, BER that encourages hiring workers formally rather than informally is likely to bring reduce average (formal) productivity; (iii) strict employment protection legislation can encourage exit from the formal sector for small entrepreneurs who cannot afford to offer such protection to their employees (Perry *et al.* (2007); and (iv) Brazil’s SIMPLES program de-linking social security contributions from the number of (formal) workers employed and instead making contributions proportional to the firm’s revenues has eliminated certain incentives to employ workers informally but may lead to perverse incentives regarding cost minimization.

<sup>35</sup> Oviedo *et al.* (2008).

<sup>36</sup> Richard Sandall (personal communication, June 2009) sees this as an additional option to those that focus on either increasing the benefits or decreasing the costs of formality.

cause the emergence of a functional and pro-poor credit system; additional incentives to invest are required. Even when in possession of titles and registered property, small-scale farmers and the urban poor most often do not put their land or modest dwellings at risk by using them as collateral for credit: collateral requirements are too high and too little risk is shared by the financial intermediary.

Ignorance of the law and a perception that there were few benefits to abiding by it were more frequent for the subsistence poor (who often have no tax liability), while evasion of taxation and avoidance of regulatory predation were more important for small firms.<sup>37</sup> The motive of corruption seems to cut both ways. Informals have little recourse to legal protection from roving bandits (corrupt official inspectors); formal firms have trouble hiding from the vagaries of inspectors in systems with weak oversight of regulatory agencies.

In some regions, even where the present discounted expected value of formality is positive, there is often a strong sense of distrust of official agencies and of lack of legitimacy of laws that still discourage formal participation. Lack of trust increases the perceptions of risk that laws or compliance terms will change or not be consistently applied over time. Lack of legitimacy leads to reduced rates of regulatory compliance and tax morality. Even support for land registration can be compromised. For example, if there is a history of elite capture of land, leaving the worst piece to the majority, then land registration would be seen to formalize illegitimate ownership. For an example, one needs look no further than Zimbabwe. Such distrust is hard to overcome in the short run; it requires the government to develop a track record of (i) promulgating laws whose compliance demands are in line with the capabilities and needs of the regulated and (ii) guaranteeing legal protections. Both of these must also be simple enough for their execution to be predictable and consistent.

*Are informality and formality mutually exclusive?* Curiously, a business can choose to be both formal *and* informal. It can, for example, operate legally regarding its employee social safety net and payroll tax obligations but at the same time hire (or subcontract) temporary workers whose activities remain in the shadow. Many business activities in the transition economies (TREs) of Eastern Europe and the Former Soviet Union—including state-owned enterprises—systematically engage in underreporting of payroll and sales (including due to fraud or barter). Likewise, this report has emphasized that there are many ways to be partly formal. One's business can be registered, one's land (or other assets, as in Question 3.3, below) can be registered, one's tax obligations can be met, and one business can be in regulatory compliance. Each of these involves a cost-benefit decision by the economic agent and each element of each decision can be influenced by BERs.

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<sup>37</sup> Djankov (2002).

## 2.2 How Does BER Affect the Size of the Informal Economy?

From a country-level perspective, two major studies concluded that the lower is the degree of regulatory burden in a country, the smaller is likely to be its IE.<sup>38</sup> This result is shown to hold with regard to specific areas of regulation as well as to aggregate indicators of the same.

BER affects the size of the IE through its influence on the informality choice of workers and firms. This paper has suggested, above, there are in fact different specific areas in which to participate in the IE. This subsection begins by examining the impact of BER on these areas. It then considers the impacts of BER on the composition of the IE, timing dimension of BER impacts, and reverse direction of causality (informality's impact on the effectiveness of BER).

### 2.2.1 How BER affects areas of informality

BER affects the size of the IE through its influence on an economic agent's decision calculus: reform differentially affects both the costs and the benefits of operating formally and informally. More specifically, BER achieves its effects by strengthening or weakening the motivations (as listed in Table 2.2) impinging on cost-benefit decision making. This fine structure to its effects means that, even for a given informal subgroup, there are degrees of informality and different yet specific areas in which members of the subgroup participate in the IE. A representative set of such areas is provided in Table 2.3. Specific BER toolkits have been developed to address each one.

*Labor informality:* For firms, labor regulation is among the most costly elements of being formal. Ironically, the very laws that are meant to protect labor lead formal firms to contract out the more dangerous jobs, both to smaller firms which use informal workers or directly to part-time informal workers.<sup>39</sup> Moreover, in such a situation firms do not have an incentive to provide worker training.

From the workers' perspective, in some countries they actually select to work in the IE *voluntarily*. For them, BERs that strengthen the enforcement of labor laws by imposing harsher sanctions on those who offer jobs in the shadow economy can be welfare-reducing if such opportunities disappear as a result (Perry *et al.* 2007). Since formal firms are the ones most compliant with such laws and are more likely to be located in urban areas, the enforcement of overly burdensome (or ambitious,

<sup>38</sup> World Bank (2005) finds this result for no less than ten specific aspects of the business regulatory environment (and its aggregate measure). Klapper *et al.* (2008) find this to hold in the case of business registration.

<sup>39</sup> While such costs might include minimum wage requirements, labor regulation costs limiting firing and shift hours, mandating social benefits (health, severance, vacation/sick days, pensions, etc.), as well as occupational safety can be source of even greater burden, especially for smaller firms. (Enste and Schneider, 2000; Eilat and Zinnes 2003).

**TABLE 2.3** Impacts of BER area on motivation to be informal

Motivation	BER reform area								
	Asset security	Financial markets	Judicial	Product standards	Energy	Labor regulation	Start up	Tax	Regulatory Process
<b>Cost</b>									
Tax evasion: Direct Indirect								√ √	
Labor regulation						√		√	
Other regulation				√					√
Fear of predation				√		√		√	√
Fraud		√		√				√	
Distrust of government			√				√	√	√
Costly start-up procedures						√	√	√	√
Ignorance		√	√	√		√	√	√	√
<b>Benefits</b>									
Bank finance	√	√							
Non-bank financial services and insurance	√	√							
Land tenure	√		√				√	√	
Government/donor TA		√		√			√		√
Public utilities					√				
Court/police access			√						
Social protection services						√			
Avoid compliance fines				√		√	√	√	√
Market opportunities				√					√

depending on one's view) labor regulations may have undesirable distributional implications regionally. On the other hand, in the absence of strong labor associations it is unlikely that workers—especially, in the informal economy—are going to receive such benefits without proactive government involvement.<sup>40</sup> In sum, these issues complicate the establishment of an appropriate balance for labor policy since wider enforcement can benefit informal workers and may pull some into the formal economy, but it can also put their jobs at risk if compliance imposes high costs on informal businesses.

*Tax informality.* Tax reform addresses formality costs corresponding to poor tax policy and administration in several ways. First, reform of tax policy can rationalize rates, deductions, exemptions and other “tax expenditure” leakages. Second, tax administration reform seeks to improve the efficiency and productivity of tax registration, collection, and enforcement as well as strengthen the revenue agencies' capacity for tax policy research and analysis. Third, systemic reforms related to decentralization and devolution can have important consequences for tax yields. Among the goals of these reforms is to permit a reduction in tax rates, which when accompanied with enforcement reform, can expand the tax base and lead to an overall increase in revenues.<sup>41</sup> The main effect of such reforms will be on the more dynamic SMEs (unofficial enterprises in Table 2.1), the firms for which tax evasion is the principle motivation for operating informally.

BER in the shape of tax amnesties reduces the cost of becoming formal. This policy, however, can be double-edged. First, a tax amnesty may also reduce the expected penalty of being caught operating informally. Second, it may further reduce the legitimacy of paying taxes as perceived by formal firms.

Ignoring possible fiscal benefits, there may be some long-term informality reducing benefits to implementing a simple (e.g., presumptive) “income tax” on self-employed individuals and microenterprises.<sup>42</sup> As viewed through the empowerment lens, the poor conditions of unprotected informal workers point to their lack of political voice and organization as a proximate cause.<sup>43</sup> The political science literature, however, notes that paying taxes encourages civic participation and increases

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<sup>40</sup> Gallin (2004).

<sup>41</sup> Lower tax rates also reduce the degree revenue collection is economically distortionary. This is because taxing labor reduces its supply relative to other inputs, shifts it to non-taxed activities, and leads to a loss of consumer and producer “surplus” or “deadweight loss” (DWL) that increases *non-linearly* with the tax rate.

<sup>42</sup> Among the many implementations of this concept is the *impôt minimum forfaitaire* (Soderback, personal communication, 21 June 2009), generally a flat *ad valorem* or specific tax assessed on the revenues of small businesses, professionals, and physical persons independent of whether a profit or loss is made. Examples can be found in such countries as Tahiti, Senegal, Romania, Mongolia, Mali, and Burkina Faso. Of course, all taxes have a burden. In Burkina Faso, for example, an UNCTAD (2009) assessment found this tax crippling the cash flow of businesses.

<sup>43</sup> *C.f.* World Bank (2001).



demands for accountability of political representatives. Hence, the implementation of a simple non-discretionary tax that can be collected cheaply and with high compliance might paradoxically lead to better working conditions for the poor. This approach has been implemented successfully in Mongolia where one section of its income tax code contains an “informal sector” tax.<sup>44</sup> As argued in Section 3.3, this requires complementary efforts by donors to encourage the creation of civil society organizations.

*Energy informality:* The desire to provide unreported energy subsidies is at heart a political decision related to a combination of employment and industrial policy and, potentially, corruption.<sup>45</sup> BER addresses this set of problems both directly, through the reform of accounting and auditing standards as well as indirectly through its government training and capacity-building components, which focus on the importance of the primacy of private sector production and a level playing field. Likewise, in some countries micro enterprises and even some of the smaller SMEs illegally connect to the electricity grid without permission. This is substantially attenuated with privatization of electricity generation.

*Product informality:* BER in this area is specifically designed to address the permit and licensing side of regulation. BER here, however, must weigh the harm to the public good caused by a poor quality, counterfeit, or dangerous product or process against the costs of ill-designed or overly stringent standards. Without reform, production of products governed by such regulations is pushed into the IE. Ironically, then, a desire to protect the public good may end up harming it.

*Financial and capital market informality.* Most developing countries have extremely primitive and geographically limited capital markets. There are very few listed joint-stock companies and SMEs are reluctant to finance investment through equity. Lending by the banking sector is typically limited to the larger firms, public enterprises, and joint ventures with foreign investors. Smaller unofficial enterprises that are too large to be eligible for microfinance, therefore, must draw on retained earnings, loans from friends and family, or money lenders.

In spite of the importance of finance, it is necessary to make the distinction between the effect of the BE on IE growth (and growth in general), on the one hand, and its effect on formalization, on the other.<sup>46</sup> For example, while it is likely that inability to obtain bank finance is an obstacle to an enterprise’s growth it is unlikely to be a barrier to its formalization. Many micro-finance initiatives, for example, do not

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<sup>44</sup> See Alevy and Zinnes (2005).

<sup>45</sup> “The McKinsey Global Institute studies showed that low productivity but well connected manufacturers are kept in business because they enjoy informal (i.e. non reported) energy provided at low prices under the cover of technical losses (India) or highly complex barter schemes (Russia).” (Palmade 2005)

<sup>46</sup> This insightful point has been made by USAID (2005; p. 19), along with the examples provided in this paragraph.

require borrowers to be formally registered enterprises. In Vietnam, no correlation was found between the degree of formalization of an enterprise and its propensity to use bank loans.<sup>47</sup>

*Asset informality.* With the majority of the developing-country population agrarian, land ownership and access is central for economic growth. Willingness to make land improvements and to follow sustainable land management practices is reduced when such property rights are insecure. Moreover, formal land ownership is generally required in order to obtain water and electricity hookups; it also facilitates access to formal credit markets. Land disputes are also a major source of civil unrest in some countries.

In response to the problems, there has been a major effort at land titling, especially since the pioneering work of de Soto (1989). BER reforms have focused on redressing incomplete cadastres, onerous/costly land registration, and intrusive government ownership of land. The impact of these reforms has been to increase the value of entering the official statistical net, a first step in becoming formal. It can also change the characteristics of informality, since this set of BER has a greater impact on informal firms in sectors or business lines that are relatively land intensive. Finally, to the extent that special efforts have made to rectify gender biases in land ownership and security, the proportion of women in the IE need not increase as a result of land titling.

Separate from land titling, a collateral registry is another registration system that has been shown to affect the size and characteristics of the IE. It does this by making impersonal exchange less risky, thereby expanding the market for economic transactions beyond one's immediate vicinity or social group.<sup>48</sup> Buyers, sellers, borrowers, and creditors may collateralize their assets to guarantee their commitment to an agreement. Of course, the collateral registry is only part of the institutional changes required for this BER to become effective; a reliable and efficient commercial court system must also exist.

*Adjudication informality.* Regarding formal means of contract enforcement through commercial courts, the less time required for judgment, the more predictable their judgments, and the less corrupt are these institutions the more attractive they become as a benefit to formality. Without an efficient commercial court system, market transactions become of smaller value, fewer in number, and more limited to personal exchange.<sup>49</sup>

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<sup>47</sup> IFC and the World Bank (2003).

<sup>48</sup> Impersonal exchange is a transaction between two parties who do not know each other or have any informal means of enforcing an agreement (North 1990).

<sup>49</sup> To truly tap economies of scale requires the power of *impersonal* exchange, where buyers and seller need not have a track record with each other to carry out business transactions.

The tendency for activities in the shadow to operate at a smaller scale than otherwise in order to stay beneath the official radar is an example of the IE's supply-side impact. However, there is also a demand-side impact to operating in the IE. First, to remain hidden, only limited advertising is possible. Second, informal firms do not typically have access to the formal commercial court system. This requires them to restrict their transactions to the immediate locale and to be with those parties with whom they have personal or social ties. This arrangement allows the parties to utilize relational contracting, informal dispute resolution, and traditional means of justice to support governance of the transaction.<sup>50</sup>

The institutional landscape of adjudication informality carries implications for BER. First, it is unlikely that BER of the court system will have a near-term effect. The system would first have to gain the confidence of the business community and prove itself as a reliable and *predictable* substitute for customary processes. Only then would informal firms perceive that benefits have increased. The newly formalized firms would then have to expand their markets to the point that the formal justice system would be called upon. Even then, training would be necessary on how to use the court system.

The rights, powers, privileges, and immunities of property law, labor law, and small business law are key for subsistence and unofficial enterprises. Yet beyond this, the linkages between formal and informal structures need to be strengthened to “empower the poor to seek remedies for injustice and to counter biases inherent in both systems.”<sup>51</sup>

Second, as long as other factors continue to cause firms to perceive formality as entailing net costs, encouraging exit to the IE, BER commercial-court reforms may not achieve impacts on the demand side. This underscores the need for multifaceted reform over a single-sector focus. For example, having a formal court system in place will be of limited value for disputes related to land if there is an incomplete land cadastre and unreformed land titling system.<sup>52</sup>

*Other areas.* The smaller the business, the more likely it is that traditional and customary mechanisms are used to substitute for missing services, markets, and statutes caused by government failure. Consider an example of each. Regulatory authorities seldom have the capacity (or believe it a priority) to operate in rural communities.<sup>53</sup> While this raises the risks faced by this population in such domains as

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<sup>50</sup> A relational contract is credible in the case where there is an expectation (or history) of repeated transactions. This is because the present discounted value of continuing the relationship far exceeds the value of renegeing on any given contract. (See Furubotn and Richter 1997).

<sup>51</sup> Citations in this paragraph come from CLEP (2008b; p. 56–7).

<sup>52</sup> The World Bank's judiciary project in Afghanistan has found that 80 percent of disputes relate to land. (Personal communication with task manager).

<sup>53</sup> Mining and forestry are sometimes an exception due to their revenue potential.

occupational safety and environmental health, the threat of retaliation to excessive violations perpetrated on neighbors can still act as an informal constraint on business. Likewise, the absence of formal insurance markets has been met through mutual aid and reciprocity among neighbors and kin. From the perspective of economic growth, both these examples ultimately limit the market size for which small business can participate. Ironically, emigration and “modernization” can result in degrading the very social capital upon which these informal mechanisms depend.

### 2.2.2 Composition, timing, and direction

In addition to the area-specific impacts of BER, there are other policy considerations of BER to take into account related to output composition, timing of impacts, and direction of effects.

*Reducing compositional distortions.* While missing the benefits of formality, informal firms may have some competitive advantages in labor markets (since they are not subject to labor regulations they can pass some of this saving on in the form of higher wages). They can also draw market demand away from the official firms with whom they compete since their prices would be lower, given their lower labor costs and their acceptance of a lower return on investment (since they escape taxation).<sup>54</sup> Likewise, a sizable IE will affect the composition of national economic output as resources get allocated in part according to which sectors are most amenable to informal activity (e.g., trade, services, and construction) rather than according to signals of real economic scarcities and comparative advantage. Finally, operating informally can require spending time and effort (resources) on bribing, avoiding licenses and taxes, and seeking private sector alternatives to public services and bank financing. In addressing the various aspects of informality, above, BER helps to reduce some of the distortions in resource allocation it causes.

*Long- vs. short-run effects.* Many BERs primarily focus on reducing the costs of registration, regulation, and tax compliance—that is, the cost of formality. Yet BERs that lead to increased benefits to formality are often even more influential. To appreciate this, consider the two temporal effects BER has on the size of the IE.

First, BER has some desirable direct short-run effects, e.g., it increases the number of formal economic actors and it increases the number of transactions of existing firms.<sup>55</sup> Yet by improving the benefits of formality BER can also have a long-term effect by stimulating investment. BERs of this type focus on such areas as more secure property ownership, a safer work environment, greater availability to low-cost alternative mediation and dispute resolution, and easier access to finance. The resulting

<sup>54</sup> On the other hand this would work against informal firms under a VAT, since when an informal firm makes a purchase which includes VAT, it cannot use the VAT paid as credit on output sales.

<sup>55</sup> Klapper (2006).

investment these benefits lead to can have a multiplier effect on the number of firms, though as argued in the response to Question 2.3, the effect may not necessarily decrease the *relative* size of the IE. As is argued below, however, affecting the BE for the subsistence poor requires incorporating into BER a more basic yet profound set of reforms as identified through an analysis of legal empowerment.

Another long-term aspect of BER is the special dynamics it may generate due to the existence of fixed costs incurred by an enterprise when it changes its formality status. An example of such fixed costs would be (re-)registration efforts and fees and the possible payment of back taxes. In particular, informality is “sticky,” i.e., the size of the IE is subject to hysteresis. This means that a small improvement or worsening in the BE can cause a business to change its formality status but not return to the previous status if the change is reversed. As an example, consider the case where a formal firm decides to become informal after having a bad experience either in the courts or with a tax inspector. If the government later improves the courts or tax administration, this now-informal firm may not seek to return to formality since it would then not want to (re-)incur registration fees or pay back taxes.

*Does informality affect BER effectiveness?* As introduced in Section 1, not only does BER influence the size and composition of the IE, but reverse causation is also observed. Some of these IE effects on the effectiveness of BER are summarized in Table 2.4.

There is a final more amorphous set of factors regarding the IE and the effectiveness of BE reform, namely, those related to cultural and historical considerations.<sup>56</sup> For example, as a result of years of oppression and social exclusion, workers and micro-entrepreneurs alike may have grown to distrust state schemes (e.g., land registration) related to their customary lands. Likewise, due to the high transaction costs of using formal institutions for contracting and enforcement “in some failed or very weak states, there is an entrenched IE that has had for many years to self-regulate and carry out many of the functions of the state”.<sup>57</sup> Such factors may make this population resistant to BE reforms meant to help them.

### 2.3 Does BER Focused on Informality Impact Economic Growth and Poverty Reduction?

The protracted existence of a large IE, whose local networks have limited reach, contributes to a country remaining trapped in a low-level economic—and social—equilibrium. Yet, is it a symptom or the disease? Is informality *bad* for economic

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<sup>56</sup> See Portes and Haller (2002).

<sup>57</sup> USAID (2005; p. 42).

**TABLE 2.4** Impact of informality on business environment by DCED component

Business environment component*	Impact of informality
Policy and legal framework	Small firm issues are not addressed in formal rule-making processes
Regulatory and administrative framework	Reduces impact of reform; increases cost of enforcement; harder for government to monitor sectors
Institutional arrangements	Increases democracy deficit, corruption, reduces knowledge of economic performance
Gender-specific business environment	Increases women's economic participation, but with social costs
SNG business environment	Brings rural areas more services as informals respond to the less profitable opportunities left untaken by larger formal firms, but such improvements may be diluted from rural emigration to urban areas

\* The categories in the first column are from DCED (2008).

growth if formal institutions are dysfunctional and corrupt? While richer countries tend to have smaller informal economies than poorer ones, the literature finds little evidence that economic *growth* in a country *per se* will cause its IE to shrink. While multivariate panel analyses find that the business environment, specifically the ease of starting a business and political corruption, remain significant indicators of total firm registrations,<sup>58</sup> from the macro perspective the literature leaves us with two unsettling conclusions. First, “it is unclear whether formalization is a cause or an effect of these higher levels of development.”<sup>59</sup> Second, “there is no conclusive evidence that formalization is in itself a prime cause of economic growth.”<sup>60</sup> What one can say is that “firms that remain small are more likely to be informal. Hence, growth leads to visibility and pressure to be more formal.”<sup>61</sup>

Discussions in Sections 2.1 and 2.2 help to explain these empirical findings. First, the discussion makes clear that the cause of the IE is not the level of economic activity, but the quality of the country's fiscal, regulatory, and social institutions, as well as its public services. Thus, while BER influences the first two areas and, therefore, the size of the IE, its effect on economic growth through formalization may only be in the long term. Second, the results of the quoted studies are for the economy as a whole, failing to recognize adequately that the IE is not homogeneous; it comprises different subgroups of economic units, each with a different potential

<sup>58</sup> Klapper *et al.* (2008; p.2).

<sup>59</sup> USAID (2005; p. 4).

<sup>60</sup> USAID (2005; p. 4). Welsh (2005) (DCED Cairo Conference paper).

<sup>61</sup> USAID (2005; p. 11).

and different behavioral responses. Some, like the subsistence workers and weakest unofficial enterprises, have little potential for significant short-medium-term growth; rather these subgroups grow extensively (in number, not firm size).<sup>62</sup> Other unofficial enterprises—both existing as well as those waiting to enter—have the potential to be much more dynamic if the BE would permit it.

Note that economic growth and poverty alleviation are different; the former relates to aggregate value added and the latter to its distribution (i.e., the well being of that part of the population subsisting below the poverty line). Statistically, aggregate and distributional measures need not move in the same direction over time. By providing a conducive environment for the more dynamic enterprises of the IE, BER can contribute directly to economic growth. There are ways to expand conventional BER so that it can also make a direct contribution to poverty alleviation rather than just the indirect (possibly net positive), trickle-down multiplier effect.

What is striking is that most BERs that are found to influence the formality decision are the same *type* of reforms recommended for private sector development (PSD) and by the legal empowerment literature to alleviate poverty in the long run. As far as PSD is concerned, this should not be surprising. Numerically, the majority of the private sector is in the informal economy, so it is fully appropriate that much of PSD *should* be about the informal economy. Moreover, BER is an important policy in PSD and an important part of BER relates to making formalization more attractive. Of course, not all BER focuses directly on the formality decision, examples being trade regulations, customs administration, and competition policy. Likewise, the set of policies in PSD that do not overlap with those discussed in this paper are primarily those supporting existing formal SMEs and large firms, for example, contract enforcement, FDI facilitation, competition policy, banking reform, and trade reform. *Viz.* empowerment, this dimension of each type of BER may involve particular design considerations, the inclusion of public education campaigns, and a longer phase-in from traditional substitute mechanisms. These reforms ultimately create secure property rights, social protection, and a safe work environment which then encourages a stake in the system as well as physical and human capital investment. Such reforms have also been shown to increase the productivity and therefore incomes of the poor. Section 3.1 provides specific recommendations on how to design BER to reduce poverty.

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<sup>62</sup> Of course, this does not mean they should be written off! On the contrary, since these economic agents predominate in the BoP they constitute the very part of the informal economy where future BER efforts have are most needed if poverty alleviation is to be addressed in a serious way. Moreover, given the significant market potential of the BoP (see Section 1) such BERs should also have a macro impact on economic growth in the long run.

## Policy Recommendations

Using the dual framework of cost-benefit analysis and empowerment this section provides summaries of the report's policy recommendations regarding the specific questions posed by the DCED.

Perhaps, however, it is first worth asking, given most informal businesses die within a short period of establishment, why a donor focusing on BER would want to assist governments in tackling the challenge of informality in the first place. And if they do, at which level (e.g., survivalist vs. dynamic SME) is it realistic for them to concentrate formalization efforts so as to generate the greatest real opportunities for job creation.<sup>1</sup>

First, for all the reasons laid out in the introduction, it is crystal clear that widespread informality is extremely detrimental for developing countries across the full micro and macro policy spectrum so a donor with parallel interests in economic growth and poverty alleviation has no choice but to address it. Second, while many of the causes of informality have deep political and social roots well beyond the scope of BER's primary focus on regulation and revenue reform, this paper also argues that since informality affects the effectiveness and impact of BER it cannot be ignored. Third, BER itself can have an impact on the size of the informal economy and, therefore, those who promote BER must take responsibility—and thus understand—the formality-informality nexus. The flip side of this is that, given the estimates of the potential size of market value foregone from exclusion and exit of the BoP from the formal economy, it is fair to say that promoting the growth of these businesses falls squarely in the “job description” of BER.

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<sup>1</sup> Thanks to Mavis Owusu-Gyamfi for posing these two questions so bluntly. (Private communication, June 2009).



While the necessity for BER to address informality is clear cut, the issue of how far down the BoP BER should go (or by what business selection criteria) to help informals has both a positive and normative dimension, so is more difficult to answer. On the normative side, the answer is outside the scope of this paper and depends on the donor's preferences for poverty alleviation and on the donor's opportunity costs of alternative projects available to fund.

On the positive side, a glance at the recommendations for BER that support the incentive to formalize reveals that most are equally valuable for SMEs—in other words, for a majority of BERs there is no real tradeoff, it is a win-win situation. On the degree to which economic empowerment reforms should be brought into BER, the DCED defines the BE to include the regulatory framework and explicitly “recognize[s] that good regulations are necessary to secure benefits, protect workers, consumers and the environment, [and] to promote the rule of law.”<sup>2</sup> Hence, it is clear that increasing security of property rights and access to justice (as well as reducing the transaction cost of their use) and promoting safe working conditions—all aspects of economic empowerment—are fair game for BER. Where matters become subjective is on the empowerment agenda's promotion of economic opportunity. To the extent this is understood as improving access to credit and markets, this is consistent with BER; to the extent this is understood as proactively *guaranteeing* credit, insurance, or even a job, then this would probably fall outside the majority view of BER. Finally, one should note that governments and donors do not have a good track record of “picking winners”, i.e., identifying sectors or firms that will succeed in the future. This suggests that it is likely to be better for BER to cast a fairly wide net.

## 3.1 Which Areas of the BE Require Attention for Reducing the Informal Economy?

The short answer is that just about all areas of the BE should be addressed, though each country needs to have its own prioritized plan to do so. Below, some general guidelines for creating a plan are suggested and then specific reforms are examined by area of BE.

### 3.1.1 Assessing the BE

With a view to reducing the costs of formality, an important service BE assistance has provided has been to facilitate across-the-board regulatory reviews, replete with public participation, both for existing as well as proposed regulation. These reviews have two objectives. First, laws are assessed to ensure that their benefits would

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<sup>2</sup> DCED (2008, 3).

exceed their costs, given the country's level of income and the capabilities of the regulated community. A particularly effective assessment method has been the "guiltoline" approach. This requires every agency that issues regulations to publish and justify its regulations before a set date. Failure to do so automatically abolishes the regulation. The approach has been applied with success in Mexico and Hungary, and FIAS has launched it in Kenya and Tajikistan with regard to licensing regimes.<sup>3</sup>

Second, the quality of application of the laws by the regulatory authorities is assessed to determine whether the authorities have the wherewithal financially, technically, and equipment-wise to administer, monitor, and enforce compliance in a transparent and consistent fashion, and with a minimum of corruption. Here, BER that establishes one-stop shops and ombudsmen (for oversight and recourse) are having a very positive effect in reducing formality costs.<sup>4</sup>

If government policy is to reduce the IE across the board and not just for the dynamic unofficial and quasi-formal enterprises, then the above assessments will explicitly need to incorporate an analysis of impediments to legal empowerment.

### **3.1.2 General guidelines for reducing formality**

Past assessments of informality have identified a series of BERs that merit implementing. A representative set of these is shown in Table 3.1. In light of our framework, what is interesting about this set of recommendations is that they are all focused on reducing the cost side of formalization. Yet given that compliance enforcement is weak to non-existent for many businesses in the IE, persuading informal businesses to register their activity and their fixed and moveable assets requires there to be consistently available and reliable benefits that they can profit from in the short-run.<sup>5</sup> Moreover, once these benefits are available for the targeted audience, a communications program should be implemented to advertise their existence and to educate informal business on their use. Education will often imply training programs, for which existing business associations may be an appropriate conduit (as the discussion of women's associations, below, illustrates).

What Table 3.1 implies is that training should not be limited to the enterprises. In addition to achieving a consistent level of enforcement, an important factor influencing the degree of regulatory compliance is the level of trust the regulated community has in government agencies. A powerful reform, therefore, is to use training and capacity building to create a new attitude within government agencies as a promoter and facilitator of BE services rather than as an enforcer of unpopular, obstructive laws.

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<sup>3</sup> Palmade (2005; p.5).

<sup>4</sup> See Coolidge and Jacobs (2006) and J. Morisset and K. Andrews-Johnson (2004).

<sup>5</sup> See Section 2.1.1 for examples of such benefits.

**TABLE 3.1** Best-practice donor interventions to reduce barriers to formalization

Motivation for action	Recommended intervention
Support broad programs of regulatory reform to simplify new and existing laws and make the business climate more hospitable to formal enterprise.	Introduce regulatory impact assessment where appropriate. Consider regulatory guillotines, national competitions to identify bad regulations (e.g., as done in Hungary).
Simplify official administration for businesses.	Review and reduce paperwork.
Design measures to create a business-friendly culture in government and improve the quality, quantity, and accessibility of services.	Consider service charters and one-stop-shops for business.
Simplify tax administration.	Consider single taxes for micro- and small-scale enterprises.
Ensure that the benefits of formalization can be made available to groups comprising individuals who would not separately have made the effort to formalize.	Make it easier to register producer associations.
Protect essential worker rights while making it easier to hire and fire workers and to employ workers on flexible contracts.	Identify areas for labor law reform.
Reduce the financial disincentives to business registration and complying with regulatory requirements.	Reduce registration fees and statutory requirements, e.g., for fixed premises, capital.
	Avoid retroactive taxation for enterprises that formalize.
Address tax morality motives for shadow activity; communicate the uses and benefits of revenue collection.	Share information on use of tax revenues, and how businesses will benefit from enhanced services.
Rationalize business registration and licensing regimes.	Separate business registration and licensing regimes from each other.
	Restrict licensing to those activities where it is justified on health, safety, environmental, consumer protection or other grounds.
	Use information technology to streamline the process and share data.
Remove negative incentives to register.	Separate the function of revenue generation from business registration.

Source: Adapted from USAID (2005; p. 26).

### 3.1.3 BER to reduce areas of informality

Recalling from Section 2.2.1, each subgroup of informal business owners engage in a range of informal activities. To be maximally effective, BER needs to be explicit about which subgroup it wishes to target and to design reforms accordingly. Table 3.2 provides examples of what these BERs would look like for each subgroup and area of informal activity. Let us briefly put these proposals into context by providing some discussion on each area.

**TABLE 3.2** BER strategies that encourage formalization, by subgroup and activity

Area of informality	Type of business informality				
	Subsistence workers	Employed/ sub-contracted labor	Weak unofficial	Dynamic unofficial	Formal enterprises
<i>Asset</i>	Address land tenure arrangements		Redress incomplete cadastres, onerous/costly land registration, and intrusive government ownership of land; establish a collateral registry		
	Set up collateral registry				
<i>Financial</i>	Integrate microfinance regulation into banking regulation			Better access to bank finance	
<i>Judicial</i>	Make customary mechanisms uniform		Increase the efficiency and reliability of commercial courts (and other official dispute resolution mechanisms)		
	Effective, affordable and accessible systems of alternative dispute resolution; legal literacy campaigns		Effective, affordable and accessible systems of alternative dispute resolution; legal literacy campaigns; oversee uniform application of customary mechanisms		
<i>Product</i>			Address permit and licensing issues; increase awareness of certification		
<i>Energy</i>	Block pricing and higher penalties; privatization of production			Reform accounting and auditing standards; government training and capacity building	
<i>Labor</i>	Weather insurance; basic health services	Increase flexibility in part-time work	Reduce retention requirements		
<i>Start-up registration</i>	Create registry for individual identification number without user fee; bundle with social services				
			Simplification of business registration at the central and local levels as well as the reform of other related start-up procedures; provision of BDS and market information		

TABLE 3.2 (continued)

Area of informality	Type of business informality				
	Subsistence workers	Employed/ sub-contracted labor	Weak unofficial	Dynamic unofficial	Formal enterprises
Tax	Exempt or make tax fixed and presumptive		Reduce rates and exemptions; capacity building and computerization to increase yields		
					Strengthen auditing standards
Regulatory (process)			Amnesties regarding payment of fines and compensation for past damages		
				Orient standards to particular sectors and firm sizes	

Notes: In practice, subgroups are clusters along a continuum; the table's cells, therefore, are likely to overlap and should not be interpreted too literally. Likewise, these recommendations must be further qualified depending on a country's level of development and administrative capabilities.

*Start-up registration.* The simplification of business registration at the central and local levels as well as the reform of other related start-up procedures directly reduce entry costs and so encourage formal sector entry. While this is typically a principal component of BER, its regulatory intent as well as procedures have historically been geared toward SMEs and larger enterprises. Such an approach, however, leaves out and risks disenfranchising the majority of the less dynamic entrepreneurs and subsistence activities, who either through ignorance, illiteracy, or lack of perceiving any net benefits (because of their small scale) have no interest in formalizing. Thus, a program focusing just on simplifying registration, while making sense economically, may not be astute politically and, by ignoring the BoP, could weaken its view of government legitimacy.

A more sensible approach than the typical start-up registration program just described would be to promote more inclusive BER by expanding its design to cover this larger target population. For example, in parallel to the standard business registration currently promoted by the IFC and others, BER could also include improved identity registration systems, without user fees, for individuals. Likewise, facilitating start-up procedures should go hand in hand with increasing the perceived (and, presumably, actual) benefits to the BoP of formality. For example, to attract subsistence informals to these registration services they could be bundled with other social services or traditional practices.<sup>6</sup> Experimentation should be encouraged to supply

<sup>6</sup> One extrémé yet very common form of informality is the lack of a legal identification card (or number). Without it opening a bank account, get a driver's license, participating in government programs or even attending school can be denied. As an example of the service bundling mentioned

these registration services through trustworthy local intermediaries.<sup>7</sup> Special efforts should be made to minimize the adverse consequences of formal registration.

This last twist highlights another lacuna. Successful compliance from the IE requires they have information about the benefits of formality. This may seem obvious but it is surprising how many government programs in developing countries fail to communicate with their intended beneficiaries. In Sierra Leone, “lack of information is the single most important deterrent to acquiring a business license—ahead of costs and inconvenience” while in Tanzania, “only a tiny fraction of the [IE workers] know anything about the myriad schemes and projects designed to assist them”.<sup>8</sup>

*Financial informality.* Informal firms have a propensity to stay small, which limits their ability to raise funds from banks. This is because, on the one hand, the fixed cost of placing and managing such small loans tend to make them uneconomical while, on the other hand, many microenterprises are either intimidated or ignorant of how to access bank credit, were it available. In this environment, informal finance mechanisms and microfinance institutions have flourished, especially since small enterprises find unduly risky the excessive collateral requirements by banks facing little competitive pressure.<sup>9</sup> Studies on Asia and Africa, for example, have found that three-fourths to seven-eighths of the IE rely on informal finance.<sup>10</sup> The success of microfinance in expanding finance opportunities to the BoP has led to a deluge of donors jumping onto the bandwagon. Having incorporated the social and organizational mechanisms that have sustained informal finance, microfinance providers have basically become formal institutions like banks but with clients who are informal groups of borrowers from the BoP. Strangely, however, few countries have embarked on the regulatory reforms necessary to reduce distortions such a two-tiered system often leads to.

Some banks have tried to link up with informal finance<sup>11</sup> “organizations”. Examples of these efforts include savings accounts for savings clubs, self-help-group onlending, adapting ROSCAs to be mutual guarantee associations, bank accounts for money collectors, and moneylender onlending.<sup>12</sup> Banks have also experimented with

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in the text, in many countries, health workers in the vaccination programs in poor communities can register each child they vaccinate (ADB 2005);

<sup>7</sup> For example, might outsourcing the partial or entire registration process to local chiefs, certified community organizations, local stores, banks, and other places where people engage in economic activities be feasible?

<sup>8</sup> FIAS (2006, p. 40) and King (1995, p. 191), respectively, as quoted in Kenyon (2007).

<sup>9</sup> My own field work in many countries has convinced me that it is the risk of losing collateral and not usurious interest rates that choke off microenterprise and household borrowing.

<sup>10</sup> Aliber (2002; 42).

<sup>11</sup> “Informal finance mechanisms are as diverse as they are ubiquitous, including institutions such as rotating savings and credit associations (ROSCAs), accumulating savings and credit associations (ASCAs), informal money lending, loan brokers, and burial societies, to name a few.” (Aliber 2002; 1).

<sup>12</sup> Aliber (2002; 39).

some of the methods that underpin informal finance and microfinance, such as the use of daily deposit collectors. The results of these initiatives have been mixed and appear not to have significantly changed the financial picture for the IE.<sup>13</sup>

Facilitating the creation of non-bank lending options (e.g., microfinance, cooperatives) may have had some paradoxical consequences on the effects of BER efforts to extend the benefits of formality downward. First, this is because microfinance is explicitly designed to serve clients in the IE and is a substitute for bank financing, which requires being formal. It is not clear how BER can encourage banks to provide these services, which often focus on self-help and financial education. Second, since the single most important factor contributing to good financial performance of groups is if the group perceives that the funds are sourced locally (e.g., from local community savings),<sup>14</sup> this suggests that the more efficiently the bank intermediates (draws on outside funds) the worse will be its group lending performance. Lastly, as informal finance evolves to take on formal aspects (e.g., impersonalized transactions), it has been found that men begin to run the very businesses that started out as woman-based and, in so doing, show a preference for lending more to men than to women.<sup>15</sup> Still, BER can also be designed to proactively neutralize the gender bias in formal financial institutions.

With these caveats, the effect of any financial sector reform reaching down to smaller firms (and households) in the IE would likely be greater if coupled with land titling, since this would provide prospective borrowers in the IE with more collateral with which to approach formal lenders. Moreover, to the extent this provides more funding to the IE the latter may be better able to increase its capital-intensity, potentially facilitating the structural transformation toward manufacturing, so critical for raising per capita income. Since formal sector lenders are more active in urban areas, this may also affect the locational distribution of the IE.

Finally, an important reform measure would be to increase the competitiveness of the banking sector. This should lead banks to seek out additional market niches, one being lending to the more dynamic small firms in the IE, who require the frequency of access, reliability, and product services that informal finance providers cannot offer. This increase in competition might also lead to innovations of financial products targeted to small firms, though clearly donor technical assistance in this regard would be a plus. Together these policies should increase the benefits of formality and thus reduce the size of the IE.

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<sup>13</sup> Aliber (2002; 41).

<sup>14</sup> Bennett *et al.* (1996).

<sup>15</sup> Aliber (2002; 45).

*Asset informality.*<sup>16</sup> In principle, the goal here is to “institutional[ize] an efficient property rights governance system that systematically and massively brings the extralegal economy into the formal economy and that ensures that it remains easily accessible to all citizens.” Among the tasks here for which more emphasis is required include promoting an inclusive property rights system that will automatically recognize real and immovable property bought by men as the co-property of their wives or common law partners, as well as clear and equitable inheritance rules.

*Judicial informality.* The reality is that the vast majority of the world’s poor rely on non-state, informal justice systems. Hence, if the objective of BER is to ensure access to justice for all business activity, then it cannot simply focus on forcing all dispute resolution through formal channels. This requires a four-pronged strategy. First, BER must reduce the transaction costs and remedy the market failures entailed in using formal channels of justice and it must increase the fairness of the system’s outcomes as perceived by the poor. This entails pursuing legal simplification, standardization, and legal literacy campaigns targeting the poor. The goal is to create a neutral, predictable, formal dispute resolution alternative for the poor in order to encourage a climate for fair settlements in the shadow of law.

Other measures of support in this area include (i) stronger legal aid systems and expanded legal service cadres with paralegals and law students, in part by gradually liberalizing the market for legal services and by reducing regulatory entry barriers; and (ii) structural reform enabling formation of peer groups (for self-help strategies) and community-based groups to pool legal risks as well as strengthening information-sharing networks to facilitate disseminating legal information.

Second, BER should consider how to strengthen and raise the quality of customary and traditional governance methods. This does not mean deferring the process of providing all economically active members of society with a formal legal identity.

Third and simultaneously, a strategy should be developed containing integration and convergence paths to the formal system. This would include combining formal or tacit recognition of the informal justice system with education campaigns that promote its evolution (e.g., toward limits on practices that perpetuate the subordination of women) and to structure the relationship between state and non-state systems. This allows the informal system to provide an efficient means of resolving private disputes, but the formal system to be used for very high stakes for the individual (e.g., criminal cases), when the legal claim produces public goods (such as general deterrence or legal reform), and when fundamental public values are implicated.

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<sup>16</sup> Empowerment-related recommendations are adapted from CLEP (2008a; p. 60).



Note that implementing these BER strategies are in addition to engaging in the other essential components of judicial reform not targeting informality, namely, to increase the efficiency and reliability of commercial courts (and other official dispute resolution mechanisms) for all firms.

Fourth, addressing the justice system requires improving access to bureaucratic justice, an area often directly addressed by BER.<sup>17</sup> Regarding public administration reforms, these include reforms that improve external monitoring and also structural reforms. The latter focuses on improving bureaucratic adjudication and grievance procedures; expanding public participation in administrative decision-making; pursuing civil service reform to expand opportunities for performance incentives in government administration; and increasing decentralization and addressing redundancy in bureaucratic services to improve efficiency and combat corruption. Regarding administrative law reforms, these include an expansion of freedom of information laws, impact statement requirements, and whistleblower protections, as well as appropriate but limited judicial review of administrative action.

*Regulatory process informality.*<sup>18</sup> The need for greater use of guillotine and regulatory impact assessment approaches has already been mentioned. Note that amnesties related to regulatory noncompliance are only feasible regarding payment of fines and compensation for past damages; the fixed costs of compliance would not be. The latter must be addressed by tailoring regulations to a firm's potential for harm (which is usually legislated by industrial sector and firm size).

At the other end, participation of and consultation with IE firms, including those at the BoP, need to become part of the reform process. As discussed below, this may require first supporting NGO efforts to organize some of the IE's larger sectors. Likewise, SNGs should be approached to determine where regulations have hampered informal-formal BoP ventures.

*Labor (employee) informality.* The challenge here is to balance the needs of worker welfare with those of economic growth. Some countries have legislated rich-country benefit schemes which are simply unaffordable and therefore lead to corruption and shadow growth. More pragmatic approaches have tackled the issue by applying a rising stepped schedule of labor regulations as firm size increases.<sup>19</sup>

Consider, therefore, scaling back labor laws impeding the hiring and firing of workers or increasing the costs of doing so in order to allow more flexible contracting, while strengthening labor laws that protect essential rights (e.g., OSH, ILO Core

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<sup>17</sup> This paragraph draws on CLEP (2008b; p. 57).

<sup>18</sup> A set of DFID/FIAS papers are forthcoming on this subject.

<sup>19</sup> Unfortunately, this also can create perverse incentives. "Anecdotal evidence suggests that Indian manufacturers often set up several plants instead of a single large one to get around labor laws." This has prevented them from reaping economies of scale. (Devarajan and Ahmed 2007 )

Labor Standards).<sup>20</sup> Moreover, rather than simply increasing the enforcement of these labor rights at formal enterprises, proactive measures should also be taken to extend these rights to workers in the IE.<sup>21</sup> Critical in this regard would be a parallel public information campaign reaching rural as well as urban areas on the applicability of these rights to all salaried workers—and regardless of their own legal status or that of their employers.

*Tax informality.* The higher the tax rates the greater is the incentive to evade and produce in the shadow. This is a particular problem for the larger quasi-formal enterprises, which recall can be both private as well as state-owned. On the other hand, higher taxes can pay for higher quality public services, many of which are more economically provided by government. This observation may be linked to one study's interpretation of findings that tax levels can be *inversely* correlated to the size of the shadow economy.<sup>22</sup> This, the study reasons, suggests it is not tax levels but unpredictable and arbitrary tax administration, volatility, and corruption that are the major deterrent to formalization. Note also that since tax evasion can put a firm at a competitive advantage, there is a coordination failure that the government creates when there is weak tax administration.

While this report urges relatively more emphasis on the benefits side, it is true that increasing the benefits of formality may not have much of an impact for larger firms. In the case of state enterprises, this is due to the fact that the shadow comes from theft and fraud (resulting from political corruption and weak management). In the case of the private sector, the bigger the firm and the larger the share of foreign ownership, the less it can risk being caught operating in the shadow; its immovable assets are too valuable and can be impounded. This may not prevent firms with both input and output trading relationships with foreign firms from engaging in such acts of tax avoidance as transfer pricing. Still, the greater are the perceived fairness and consistency of the system of revenue raising and the more equitable and efficient are government expenditures, the greater is the fiscal system's legitimacy and, hence, tax morality. Achieving the latter actually increases tax yields with lower enforcement and collection costs.

*Product informality.* Donors can help to fund a regulatory review to assess whether standards are set so that their expected social benefits exceed costs. Likewise,

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<sup>20</sup> “Core Labor Standards” include freedom of association and the “effective recognition of the right to collective bargaining”, freedom from forced labor, the “effective abolition of child labor”, and nondiscrimination in employment. Whether these should include putting in place social protection mechanisms, however, is another question.

<sup>21</sup> The degree to which this might level this aspect of the playing field for formal and informal firms will depend on how workers will be able to bring purported infringements to the attention of a government agency without potentially incurring non-compliance penalties themselves due to their informal status, or at least the fear of incurring them (given workers' likely ignorance of the law in the first place).

<sup>22</sup> USAID (2005; p. 15).

priorities should be set: capital market constraints mean that firms may not be able to improve compliance across the board.

BER that addresses the other areas of informality should ultimately help to expand market opportunities. This should encourage the appearance of middlemen in distribution and marketing. They are at the point in the value chain where product standards can be most economically imposed (so that middlemen demand higher production quality from suppliers). Ultimately, improvements will only become sustainable if indigenously demanded. Therefore, public awareness campaigns should be part of a government's strategy. In the food sector, for example, agricultural extension and related technical assistance can be provided by donors under the condition that public awareness campaigns are in place.

*Energy informality.* Household energy production by burning wood is detrimental to the environment (from deforestation and gashouse gas releases) and to health (from inhaling SO<sub>2</sub>). Small enterprise own generation of electricity is inefficient, reducing competitiveness. While clearly these are rational responses to the lack of infrastructure, there are some actions which can still help here. Most important is developing a national energy strategy and one that addresses the IE. Such a policy should be based on detailed surveys, consultation with the IE, and an eye to emerging technologies. In addition to infrastructure planning, among the components to consider are expanding efforts to implement block pricing.<sup>23</sup> Another, where market size permits, is to privatize electricity generation (but not the grid).<sup>24</sup> Among the technologies to consider are biofuels and the use of the newly emerging low-cost and efficient solar panel technologies. Each of these components requires the right BE and so has implications for BER.

## 3.2 How Should BER Address Informality in Firms that are Rural, Owned by Women, or Within Specific Sectors?

Frequently, the need for BER on the IE is not uniform but gender, region, or sector specific.

*Gender-oriented reforms.* Without doubt among the most important BERs to address informal business activities by women would include promulgating laws and statutes to create gender neutrality in ownership rights. These would include

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<sup>23</sup> This involves a tariff schedule in which consumers of low levels of energy pay a lower unit price (and one below long-run average cost) than consumers of high levels of energy. Hence, the latter subsidize the former to ensure cost recovery.

<sup>24</sup> "Many smaller African countries have found themselves in financial difficulty with privately run monopolies (often at least partly foreign owned) due to (i) lack of economies of scale in production; (ii) "dubious" promises and representations by incoming investor; and/or (iii) poor public/private management of relations and investments." (Dorsati Madani, private communication, June 2009.)

requiring joint titling, establishment of common property statutes, and laws obligating equitable inheritance. Recognizing the inevitable gap between *de jure* and *de facto* law, the ILO believes implementation would be strengthened by establishing a compliance unit to constantly monitor gender issues and follow up on enforcement.<sup>25</sup> The relevance of such an authority would be itself strengthened by the presence of effective women's associations (see below). Some experts, however, worry that this would simply increase bureaucracy,<sup>26</sup> though there are precedents: BER in some countries already establishes commissions to ensure compliance with competition regulation.

As many case studies now confirm, an important part of creating the political will to pass gender-oriented BER as well as of supporting its implementation is through “organizing low-income women entrepreneurs into local membership-based organizations in order to ensure the sustainability of targeted interventions in support of their enterprises and appropriate changes in the [business] climate.”<sup>27</sup> Since such organizations tend to “[combine] organizing and advocacy strategies ... with a full range of economic and social services ...” they not only increase the effectiveness of the BER but extend its reach deeper into the fabric of society by “support[ing] the linkages between women's lives and their work.”<sup>28</sup> Hence, support for the formation and strengthening of women's associations should be considered as part of a BER package that aims to include the informal economy. In addition to technical assistance, competitively allocated grants to women's entrepreneur associations should also be considered.<sup>29</sup>

Finally, praise must be given to the recent efforts of The Economist Intelligence Unit (EIU), in collaboration with the World Bank and IFC, to develop “the Women's Economic Opportunity Index, a new measurement of employment potential and entrepreneurship for women across more than 100 countries. The index will be comprised of approximately 30–35 indicators divided across six thematic categories: Labour rights and legislation; Credit and finance; Education, training and business knowledge; Tax laws; Social customs and traditions, and General business environment.”<sup>30</sup> With this indicator, for the first time donors, practitioners, and governments alike will be able to assess and compare more objectively country performance—and progress—in the area of gender equality in the BE. Moreover, the rich degree of its sub-indicators will help pinpoint policy and implementation weaknesses for reform.

<sup>25</sup> CLEP (2008a).

<sup>26</sup> Dorsati Madani of the World Bank's Investment Climate Department being one (private communication, June 2009).

<sup>27</sup> Chen *et al.* (2003; 36).

<sup>28</sup> Chen *et al.* (2003; 34).

<sup>29</sup> Of course, reinforcing equality educations in schools is paramount (D. Madani, *op cit.*). Perhaps a more radical suggestion would be to include basic business skills as part of this education.

<sup>30</sup> EIU (2009; first page, unnumbered).

*Rural-oriented reforms.* The rural sector, almost by definition with its greater geographic extent and lower population density, not only is subject to higher marketing and distribution costs but also higher transaction costs of formality. Government offices involved in regulatory and fiscal compliance tend to be far away and the rural sector's lower incomes mean that official fees are regressive. Likewise, access to public and private services—among the benefits of formality—is less available. Hence, incentives for the financial sector and increased budgets for the judicial agencies would need to be considered to better service this group if it is to decide that formality is worth it.

Rather than repeating the impact of each BER on rural informals, it is worth identifying several reforms in the area of property rights that should be pursued. These include legalizing guidelines for forced relocation, including fair compensation; recognizing a variety of land tenure, including customary rights, indigenous peoples' rights, group rights, certificates, etc., including their standardization and integration of these practices into the legal system;<sup>31</sup> and carrying out state land audits with findings published to discourage illegal taking possession of public land.<sup>32</sup>

BER should consider creating rental markets for land and real property, since leasehold tenure can be insecure or there may be restrictions constraining land leasing, which are underdeveloped in many countries. The idea is to facilitate renting so as to improve access to land by those remaining in the rural sector. Likewise, more robust and transparent guarantees should strengthen the position of slum dwellers in rental arrangements and protect them from arbitrary eviction.<sup>33</sup>

*Sector-oriented reforms.* There are a host of sector-specific BERs discussed in the report. Among these include actions to support street entrepreneurs, artisanal miners, and textile workers. Curiously, these show that often local laws and regulatory enforcement on informals can run contrary to central government development (anti-poverty) and economic growth policies.

### 3.3 How Can a Donor Support Be Reforms that Encourage Formality?

Here the donor's "Hippocratic oath" is nicely put by Sida: "Appropriate policy frameworks and strategies aimed at the informal economy should be developed without hampering the potential of the informal economy for job creation and economic growth."<sup>34</sup> With this in mind, the recommendations in the report identify three areas

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<sup>31</sup> Importantly, CLEP associates the property rights of indigenous peoples with the issues of intellectual property and recommends strengthening protection of traditional cultural expressions, traditional knowledge, and genetic resources against misappropriation and misuse.

<sup>32</sup> List is adapted from CLEP (2008a; p. 60).

<sup>33</sup> CLEP (2008b; p. 105).

<sup>34</sup> Becker (2004; 34).

in which donors can productively support BER that encourages formality. These include assistance in development planning, direct technical assistance and funding of BER, and support for complementary reforms outside of the ambit of BER but synergistic with it.

### 3.3.1 Support for development planning

By now it will be clear that the effectiveness of BER depends on a host of parallel efforts including security and stabilization; non-BERs in banking, trade and investment, and public enterprise and privatization; macroeconomic stabilization policies; and even infrastructure investment. This is a tall order since ultimately a government (and donor) has only a limited amount of reform capacity and funding. Hence, having a realistic development plan—and feasible and ongoing process to update and monitor it—is, therefore, essential to avoid squandering what is available on ineffective and even counterproductive efforts.

*Support for a strategy.* Too many governments do not understand that a strategy is a limited set of objectives together with dedicated resources and identified constraints. As a result, development strategies have excessively long lists of “priorities”. This is inimical to successful strategy. Likewise, such strategies tend to say little concrete about their funding. Often they appear as unfunded mandates, which again is not conducive to successful implementation.

*Support creation of a planning process.* Helping the host country put together a development planning *process* would not just include involving the relevant ministries and supporting agencies. It would also include creating buy-in from the main international donors and creating a public participation process to enlist contributions from non-government organizations.

*Support for efficient funding.* All too often donor cooperation is an oxymoron. Donors compete with each other for recipient attention with predictably unsatisfactory results. The government becomes overwhelmed with donor compliance requirements and the ministries then have little time to carry out their own activities. Aid becomes supply driven and often loses its legitimacy. An alternative is to corral donors into supporting the creation of a development plan and funding it through a development (trust) fund whose disbursement is driven by the plan and efficiency rather than donor-country agendas.

*Support education.* This would be done on several levels. First, better data collection (including by gender) and analysis capacity must occur so that policy makers are not driving blind. This would include developing indicators for each policy objective. Second, the government should be educated on the role of the IE, how it fits into a country’s development, and that it is not a sector that is *per se* something to eradicate on sight through purely more and better enforcement. It should be considered

a barometer of the quality of government. Moreover, the government agencies must have their mentalities modified so that they see that they are there to facilitate business opportunities for all, not to act as policemen (or rent-extracting gatekeepers!). Third, donors should stress the importance and creation of a strategic communications plan. Such a plan would provide the overarching framework to guide the development of media-, region-, and even demographically specific public information campaigns. These campaigns would have the objectives of strengthening the legitimacy of reform efforts, encouraging public (civil society) participation, and on teaching civic responsibilities. Fourth, donors can encourage more rigorous evaluation of BERs.

### **3.3.2 Directly supporting BER**

At the level of direct support for BER there are still a number of more and less tangible areas of assistance that donors may support.

*Concrete actions.* If donors adopt the policy that fairness and poverty alleviation count equally with economic growth (especially when short-term), then they need to help the government understand the importance of ensuring that BER also serves the poor and not just its dynamic segments which have the greatest potential to contribute to growth. While Section 3.1 provides several examples of such reforms, a legal identification number is surely among the most critical. Another would be collateral registries that are accessible with low financial and transaction costs. Peasants and urban street entrepreneurs alike use moveable property as means of production. To the extent that this type of property is held securely and can be used to access credit to create and grow businesses, the poor will have increased opportunities. Collateralizing moveable and intangible (business skills and informational schemes) property by creating a moveable and intangible registry can play an important role in a nation's development strategy.

Assuming that donors are willing to consider BERs that improve the benefits side of the formality ledger, they could assist recipient governments in allocating their efforts and funds better among cost-reducing and benefit-expanding BERs to achieve a more satisfactory level of informality. Some may object to any level of informality greater than zero being "optimal". However, for the reasons stated in the text, when enforcing a regulation on a business subgroup results in net *social* costs, then turning a blind eye to some level of noncompliance *in the short run* will raise social welfare. In this case, as noncompliance expands to other subgroups, social welfare will rise by smaller and smaller amounts. At the point where further increases in noncompliance yield no further increase in social welfare, then the total level of noncompliance may be called "optimal." Of course, the long-run objective should be to improve regulations, lower their associated transaction costs, and focus them where net social returns are positive. As an example, consider the case of Mongolia where thousands of artisanal informal miners were in violation of environmental regulations (drafted

to apply to large international mining conglomerates), which they would need to comply with if formal.<sup>35</sup> A government campaign to impose the environmental regulations on these informals would either lead to excessive levels of remediation or unemployment. Until the environmental code was changed to reflect the case of artisanal mining, some level of non-compliance was socially beneficial.

Despite a plethora of economic indicators, donors should consider funding the collection of additional indicators to allow governments, citizens, and donors alike to compare and even track the nature, causes, and evolution of informality. One set of indicators could measure the degree to which the poor in the IE are able to exploit their assets and knowledge to generate sustainable income streams. A second set could capture perceptions of the components of the formalization decision, as suggested by the first column of Table 3.3. A third set could measure the quality of the *actual* benefits listed in the second half of the first column of Table 3.3. A fourth set could encompass SNG performance along each of the dimensions of BER reform; these would be similar in nature to the *Doing Business* series, only at the SNG level.<sup>36</sup> In this latter case, such efforts might not only increase government accountability but at the margin also increase the willingness to formalize since “evidence suggests that compliance rates go up when businesses know what they are getting in return for their payments”.<sup>37</sup>

Another area of attraction, particularly for smaller firms, is the provision of BDS and creating government funded (though not necessarily provided) up-to-date market information services. These may be tied into expanded statistical data collection activities. For example, such information could relate to domestic demand conditions in non-local markets (say where a country is large or comprises multiple islands) and international prices (to strengthen the position of subsistence farmers and micro-enterprises when negotiating with middlemen). It could also relate to the prices of inputs. Information efforts could also feed into investment and trade promotion efforts by providing input and capital goods transaction price information in hard-to-service localities in order to stimulate greater supply.

*Policy considerations.* There are several policy considerations that donors could bring to the attention of reforming governments. First, fairness and legitimacy of reform have an important role in its effectiveness and sustainability. Donors should, therefore, design and implement reforms that not only reduce the costs of formality but also lead to results that are perceived as fair and legitimate. This requires a participatory *process* of designing and implementing reform that is perceived as

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<sup>35</sup> Of course informals were also obligated to comply with the environmental code but, by becoming formal, they appear on the regulator’s “screen” and greatly the risk of detection.

<sup>36</sup> See the discussion of inter-jurisdictional competition in Section 4.2 for applications with SNG indicators.

<sup>37</sup> OECD (2006; 33).



legitimate: laws must be anchored in existing values, customs, and structures. Public participation and legitimacy also increase the beneficiary's stake in the results which strengthens sustainability. To augment and leverage public participation, education, training, and public relations components need to accompany the reform process. This is especially the case with reforms whose *de facto* implementation requires significant cultural or political evolution. This means promoting *incremental* change while encouraging the process to continue toward the long-term goals.

It is revealing to note that, while each firm makes a decision on formality, its decision will also depend on the actions of others. For example, if weak regulatory and fiscal enforcement leads its competitors to evade taxes and be non-compliant with regulations then paying taxes and complying with regulations will raise the firm's costs with regard to its competitors and potentially force it out of business. This has been confirmed in field studies.<sup>38</sup> This has led some analysts to propose institutional solutions to address this "coordination" problem, an example being business associations that make the benefits of membership dependent on compliance.<sup>39</sup>

Finally, donors can continue their efforts to make the links between BE and the IE clearer to local policy makers. Examples include (i) too-high food standards can lead to a large informal supply; (ii) poor intellectual property policy can lead to informal provision of substandard products; (iii) high import barriers can shift supply from formal manufacturers to informal smugglers; (iv) water subsidies and inefficient government supply lead to sub-standard informal water supplies at high prices; and (v) onerous or costly business registration and licensing reduce new formal FDI entrants.<sup>40</sup>

### **3.3.3 Complementary policies to increase BER effectiveness in the presence of informality**

There are other reform strategies which affect the BER effectiveness and the formality decision but are not covered by BER initiatives. Some of these are meant to level the playing field between formal and informal firms that compete with each other by forcing each sector to internalize the social costs of their actions. Part of the idea here is to balance the direct funding of the social safety net between government and the private sector in such a way as to achieve appropriately feasible social objectives at the least cost, taking account that placing too much onus on the private sector reduces its incentive to grow, pay taxes, and employ workers. This in turn lowers government revenues to meet its share of social obligations and may even throw more workers onto public support.

Perhaps the area with greatest potential in this regard relates to increasing the benefits of formality. Such areas as more secure property ownership, a safer work

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<sup>38</sup> See Alevy and Zinnes (2005).

<sup>39</sup> Kenyon (2007).

<sup>40</sup> These latter examples are from Palmade (2005).

environment, greater availability to low-cost alternative mediation and dispute resolution, easier access to finance have already been addressed. The literature also emphasizes the importance of greater investment in primary and secondary education and vocational training, as well as the legal empowerment of women. Other areas that have been shown to increase productivity and hence increase the pool of potentially dynamic entrepreneurs relate to the expansion of low-cost health clinics and more inclusive approaches to social protection and social security (delinked from the employment relationship). Most of these reform efforts have been considered the domain of poverty alleviation policy. Yet as the paper argues such reforms can also improve the BE for informal business and, therefore, may be considered complementary to BER. One might even ask whether some of the social protection benefits should be withheld from those who refuse to register. While, below, this paper counsels more research, one would imagine a two-part answer. First, this would probably not be wise since the positive externalities of such benefits are likely to far exceed the social benefits of formalization. Second, it would probably be better to encourage formalization by providing a simpler, quicker, and cheaper registration process, on the one hand, and by improving the quality of those business services that formality avails (e.g., commercial courts, asset registries, an efficient customs authority, public utilities).

Decentralization and devolution can also affect the size and characteristics of the IE by acting to reallocate regulatory responsibilities to lower levels that are closer to the economic unit of regulatory interest. From the regulatory perspective, the rationale for such reforms is that greater familiarity with local conditions will aid the regulator to monitor more effectively and to design better compliance schedules. Equally, the transaction costs of public participation (and therefore the expected benefits) are much lower for businesses when key laws and statutes are promulgated and enforced at the local level. This is the cornerstone of democracy. Bringing accountability down to the local level therefore, can increase the pressure on SNG to improve its performance—and improving the fiscal and regulatory quality of the local BE, in particular. Moreover, all of the above improvements are likely to increase the confidence of informals in the value of becoming formal. Finally, while decentralization carries its own risks, the emerging consensus is that in the medium run these are lower than maintaining a unitary state.<sup>41</sup>

While decentralization and devolution may be considered as a type of vertical reorganization, civil service reform and executive branch rationalization may be considered a type of horizontal reorganization. Civil service reform, which often raises both the capabilities as well as the salaries of government officials, is designed to improve professionalism and thereby reduce corruption and the time and effort required of firms in their regulatory and administrative interactions with

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<sup>41</sup> Bahl (2008).

government agencies. Among the objectives of executive branch rationalization is to resolve conflicts of jurisdictional overlap within and across ministries. This serves to make the application of regulation more uniform, consistent and predictable. Again, these reforms reduce the risks, corruption, and time and effort required of firms in their regulatory and administrative interactions with government agencies.

In general, donors should encourage governments to promulgate and enforce laws that enshrine the fundamental principles and rights at work (under international labor standards),<sup>42</sup> especially freedom of association and collective bargaining. While this may seem counterintuitive, it has been found that “[i]t is almost impossible to formalize unorganized informal [economy] enterprises. The best approach is to work through existing informal organizations.”<sup>43</sup> Primary among these are informal business associations (e.g., women’s self-help groups), whose institutional strengthening, in any event, brings multiple benefits.<sup>44</sup> These organizations are different from the national trade associations, which are dominated by a small number of larger firms, particularly in manufacturing, a situation which discourages micro and small enterprises from wanting to participate in them.

More subtly, donors should be able to increase the effectiveness of BER in addressing the IE by using modern monitoring and evaluation (M&E) techniques to develop a better understanding how the design and implementation of their projects affect outcomes. While donors have always engaged in “policy research”, until recently donors and governments alike have shown little institutional interest in determining whether outcomes can be rigorously attributed to their interventions (despite much lip service historically to the contrary).<sup>45</sup> Motivations for this change of heart come from (i) an emerging consensus that the local context of BER and the demand and participation of informals for it are critical to success, (ii) frustration related to the mediocre success rate (and sustainability) of the standard one-size-fits-all formalization reforms of the past,<sup>46</sup> (iii) the need to show effectiveness to their funders (generally the taxpayer) in an age of tightening budgets and, as a result, the greater importance of pilots—and their careful assessment—prior to scaling up interventions nationally, (iv) the growing appreciation of indicator-based approaches<sup>47</sup> and, (v) the urgency of addressing poverty in a world of fragile states.

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<sup>42</sup> See Footnote 99 on ILO Core Labor Standards.

<sup>43</sup> Kenyon (2007).

<sup>44</sup> ILO (2005).

<sup>45</sup> See Espina and Zinnes (2003) for a treatment of this issue.

<sup>46</sup> This may sound harsh. The statement primarily refers to the programs to formalize firms, not to the great progress made in red tape analysis and improving the business and investment environment of formal firms. For a critique of aid to date see Easterley (2006) and Espina and Zinnes (2003).

<sup>47</sup> For example, the *Doing Business Indicators* seem to have taken on a central role in IFC and World Bank projects.

Several M&E methods have been used such as fielding international teams to qualitatively interview stakeholders, collecting before-and-after indicators for either non-statistical (and sometimes contractual) targeting or non-experimental statistical analysis, and using quasi-experimental or randomized impact assessment (RIA),<sup>48</sup> presumptuously referred to as the “gold standard” of evaluation.<sup>49</sup> Given the persuasiveness with which RIA advocates have argued for the use of this potentially powerful tool as the default method,<sup>50</sup> more and more donors have begun to use it.<sup>51</sup> While greater use of rigorous in-project evaluation is surely called for, the literature is clear that no one method dominates.<sup>52</sup> Outcome attribution does require the application of rigorous statistical methods, the choice of which depends on the nature of the intervention and its political feasibility. Monitoring, on the other hand, just requires data collection for indicators. Scaling up and replication of an intervention to other sets of initial conditions require substantial supplementing of quantitative techniques with qualitative field assessments as appropriate.<sup>53</sup> Unlike many indicators used to date, however, project-level M&E requires indicators to be independently set (i.e., not by the agents who would have an incentive to make them slack variables) and to be “ungameable” (there should be no short cuts to affect them) and salient (only addressing project objectives should influence them).

### 3.4 What Institutions are the Most Appropriate Program Partners?

This question should be evaluated from both the recipient country’s as well as the donor’s side.

*The donor’s side.* Many of the changes that can lead to sustained improvements require incremental reforms since they operate close to the cultural level. This means

<sup>48</sup> Among the other appellations for RIA are randomized control trials, randomized field trials and sometimes just impact evaluation. Quasi-experimental methods use statistical techniques to compensate for selection biases and other threats to internal validity in a randomized trial. These methods are also used in the case of “natural experiments” in which an intervention was made outside the evaluator’s control, either by nature (e.g., a natural disaster) or by another agent (e.g., a previous government policy).

<sup>49</sup> Roughly, in RIA the intervention (“treatment”) is randomly assigned to part of the target population and the average effect on a set of outcome indicators of the intervention for a random sample from the treated group is later compared to the values of the same outcome indicators for a random sample from the non-treated (the counterfactual or “control”) group. The difference is then attributed to the intervention.

<sup>50</sup> For example, Duflo and Kremer (2005) and Banerjee (2007).

<sup>51</sup> The MCC and the Gates Foundation are particularly active in this regard.

<sup>52</sup> Given the stridency of “randomistas” the literature has hit back on the limits to and even dangers of using RIA. See Ravillion (2008) for a review of this literature.

<sup>53</sup> In general, even when an RIA application overcomes selection bias, contamination issues, and measurement biases, it is typically impractical to implement it in such a way as to achieve significant external validity. Hence, assessing a project’s implications for scaling up and replication require using additional quantitative and qualitative methods.

that a long-term strategy should be developed and that a similarly long-run perspective is required of donor initiatives. Some donors are better at this than others. Some countries and donors are experimenting with multi-donor-financed development funds in this regard.<sup>54</sup> This would be a major step forward and should be pursued.

A thornier issue relates to donor cooperation itself, which experience suggests leaves much room for improvement. The DCED and its BEWG appear to be exceptions to the rule, but in fact shed light on it. When a donor, operating in a country, discovers another donor there with complementary interests, a win-win opportunity would seem to exist for collaboration and cooperation. Informal work groups are often even established with this in mind. Unfortunately, each donor's program process, pipelines, and budgeting are on different cycles and with different demands and constituencies. This makes it hard for all but the shortest collaborations to work well. On the other hand, where a program is created by a dedicated temporary multi-donor organization, such as the DCED, the GEF, the institutional calculus and incentives change and longer-term joint activities become feasible. Donors have finally come to publically recognize that this donor dynamic should be taken into account when considering among donor institutions what the most appropriate program partners are. The key initiative in this regard is the Pars Declaration on Aid Effectiveness.<sup>55</sup> The agreement, signed by almost 100 countries, insightfully identifies key areas of aid coordination and harmonization for donors and partner countries to address so as to increase the effectiveness of development assistance. It also establishes a series of indicators with targets for 2010, permitting countries remarkable flexibility to meet them within their own institutional constraints (though no penalties are included for countries missing targets).

Finally, it is important to note that the totality of donor funds worldwide is simply insufficient to pay for all the BERs in all the countries that need them. Hence, it is imperative for donors to engage "demonstration" reforms from which other countries can learn and choose from. As will be seen in Section 4.2, many opportunities remain for experimentation and innovation in the field of BER. Past experience suggests that bilateral donors are more willing than multilaterals to engage in such learning activities.<sup>56</sup>

*The recipient's side.* Prior to examining this aspect of the question being posed, some caveats are in order. First, an explicit finding of this report is the inappropriateness of one-size-fits-all policy implementations. Hence, while several recommendations can be made regarding host country program partners, they must be evaluated on a country-by-country basis and adapted. Second, donors

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<sup>54</sup> See Section 3.3 for a discussion of this type of intervention.

<sup>55</sup> OECD (2005).

<sup>56</sup> Collier (2002).

must be careful not to create incentives such that reform is supply-driven by those who benefit from program spending (both donor and recipient organization employees, for example); they must create indigenous sustainable demand, economically and politically, if BER is to be legitimized. One approach here is to design programs to be performance-based; another is to utilize project design and implementation mechanisms that are genuine collaborations with the actual groups of targeted beneficiaries (thereby sidelining the “acquisitive” central government level).<sup>57</sup> Third, massive informational asymmetries exist between the donor and central government, on the one hand, and the realities and nuances on the ground, on the other. This necessitates the collaborative participation of local partners. These are potentially of three types: non-governmental civil society organizations, sub-national governments, and territorial units of central government agencies. As program partners each of these offers certain benefits—but presents certain risks. Whichever local partners are picked, the greater is the local buy-in desired and the more idiosyncratic are the skills the partner needs to acquire then the greater is the need to provide convincing expectations of long-term funding. As discussed above, those can pose problems for some donors.

These caveats should provide some general guidelines as a donor contemplates its program partner options. To these it is possible to add some more specific concerns.

One danger that seems to take on many guises as reform is contemplated and the donor seeks program partners relates to what one might call the “fox in the henhouse”. This syndrome manifests itself when a donor assigns functions to a program partner that result in a conflict of interest. One classic situation is where a service provider (broadly defined) is also asked to be responsible for its own oversight. In countries with significant informal economies, government institutions simply do not have the administrative capabilities to enforce the “Chinese walls” required to avoid such conflicts.

To ensure the long-term momentum of BER that includes the interests of the IE, it is hard to overstate the importance of creating and supporting civil society organizations representing various beneficiary groups which then have the opportunity to participate in advocacy and public regulatory proceedings.<sup>58</sup> This strategy empowers the constituencies who “win” from the reforms. These organizations in turn provide the government’s reformers with political cover as well as the valuable ground-level information so necessary for successful implementation. These groups can also be among the donor’s program partners for monitoring the implementation of BER. For these reasons, one of the reforms proposed in Section 3.1 (see “judicial informality”)

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<sup>57</sup> Examples of past practice are community-driven development schemes and the MCC’s practice of having compacts developed through sector-level, public-private forums.

<sup>58</sup> See, for example, Dyce (2006) and Rinehart (2004).

is to protect the right to form peer groups and community and sectoral associations. Likewise, Section 3.2 recognizes the key role of women's associations in promoting BER and ensuring implementation of a more gender-neutral BE.

The strategy of organizational empowerment can present significant challenges, however. First, experience shows that when donors create NGOs, the latter are not generally sustainable without continued donor financing. Second, there can be a tradeoff when members are of very different size. For example, while a benefit of formality is that it affords greater access to trade associations and public participatory forums. However, in practice, trade associations are often dominated by a very few of the largest firms, whose interests they support. Likewise, few micro or small enterprises have any interest or time to participate in public forums (which, anyway, are often far away from them).

## Outstanding Issues and Opportunities

This array of policy recommendations has raised as many questions as it has answered. While donors have shown much innovation in addressing informality, there is still no consensus treatment. Given the diversity of the IE, this is perhaps to be expected. While Section 3 lays out a host of recommendations, much remains to be understood about the interactions between the IE and BER. Section 4.1 summarizes a number of these. Complementing the recommendations of Section 3, this paper ends by identifying a set of additional opportunities that are at best underemphasized in the literature and that deserve greater attention.

### 4.1 Outstanding Issues

At the most general level, the report points out the profusion of terms to describe the IE and laments the challenges this has created when trying to compare findings in literature. The DCED adopts the term, “informal economy” (which the economics literature does not, however, associate with formal firms) and expands it to cover the full gamut of unrecorded (otherwise legal) activity targeted by BER.<sup>1</sup> This report argues that while it is fine to adopt this term, the DCED should consider using “informal economy” as the general term and then specific terms for each of its subgroups (as defined by their different behaviors and often different policy requirements).<sup>2</sup>

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<sup>1</sup> This is the term that the ILO (and, therefore, officially, its 180 member-states) has chosen to use. OECD statistics uses “unobserved economy”. See Enste and Schneider (2000) and Eilat and Zinnes (2002) for examples of the term in the economics literature.

<sup>2</sup> Examples of activities that the literature would not consider informal are under-reporting by medium and large enterprises (including state-owned), monitoring and compliance inadequacies by the fiscal and regulatory authorities, and measurement errors by the national statistics agency.



Unresolved is the question of whether the definition of BE should remain as above (DCED 2008) or potentially be expanded to include complementary policy areas that the analysis found would enhance the effectiveness of existing BER instruments. Among such policies would be some of those pursuing forms of economic “empowerment,” which can be more proactive than the standard set of BER instruments, which operate through passively strengthening the business enabling environment. These more proactive policies raise some thorny policy questions, such as what the DCED’s stand should be on the degree of human rights a government should provide (or aim to guarantee) for a given level of development.

Beyond these semantics, it is also worth mentioning some representative issues that remain unresolved for each of the questions discussed in Section 2 and 3.

*Why do firms choose informality over formality?* While this report has drawn on case studies to address this question, there is very little rigorous, quantitative evidence by informality subgroup on the relative importance of weaknesses in particular areas of the BE that inhibit formalization. Likewise, from the perspectives of government expenditure and implementation feasibility, rigorous empirical evidence is lacking on when benefit-side improvements should take precedence over the cost-side focus of more standard BER. This leads to two needs. Can a survey instrument to assess which side would be more important to the formality decision of each sub group be developed? Can a comparative cost manual to aid government in deciding which side would be more economical to address first be developed?

Since the net costs to formality often grab the attention, it is easy to forget that business is first and foremost about risk and uncertainty.<sup>3</sup> To what extent does the unpredictability of the formal regulatory environment lead subsistence entrepreneurs and households, who have a high degree of risk aversion, to remain informal? As a first step in reform, this variance may be easier to reduce than bringing down the average costs.

*What areas of BE require further attention?* Since this question is examined in depth elsewhere,<sup>4</sup> below is a list of just those areas for which the answer and intervention efficacy may vary by informality subgroup and by region:

- (i) To what extent should the benefits side of BER include elements of labor and business rights as specified in the *Fundamental Principles and Rights at Work* and the *Decent Work Agenda*?

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<sup>3</sup> The difference between these is that entrepreneurs hold subjective probabilities on the former but not on the latter.

<sup>4</sup> For example, DCED (2008).

- (ii) To what degree should particular benefits of formality be offered to informals if doing so would contribute to economic growth, or should the benefits be withheld as an incentive to becoming formal?
- (iii) How can and should standard BER be complemented with support for traditional and customary governance mechanisms, especially for informality in the justice sector?
- (iv) What is the most effective sequencing of reforms? How does context impact the sequencing of reforms? Many reforms “are time consuming and hard to predict in their final outcome due to political contingencies. Should governments, therefore, first design the most urgent policy measures needed to improve the property access and security for the poor, and then to assess if the legal basis for the measures is sufficient? If this is the case, it might be more efficient to seek improvement within a given legal framework. In many cases, however, the implementation of pro-poor property rights, especially for customary owners and women, requires legal (statutory or customary) or even constitutional reform.
- (v) For each type of regulation and level of administrative capability, to how small a firm should such regulations and registration apply? And how does the government optimize the cost-benefit decision for this?
- (vi) What aspects if any of social protection for informal entrepreneurs should be added into the BE service bundle? What guidance can be provided concerning the right balance between improving worker employment conditions and increasing private sector competitiveness?
- (vii) Can the cost-effectiveness of micro-business incentives (including government procurement, tax rebates, and subsidies) in encouraging formalization and increasing economic growth of the dynamic segment of unofficial enterprises be tested?
- (viii) Might it be cheaper and quicker to reduce unpredictability of the regulatory and fiscal areas discouraging formality as a first step to reducing the average costs themselves?

*Women, rural zones, and specific sectors.* Concerning informal women entrepreneurs, it would be interesting to know the potential effectiveness of (i) strategic communication alternatives in expediting a society’s readiness to confer formal business rights to women and (ii) competitively allocated grants to women entrepreneurship associations. Concerning rural areas, conflicts often revolve around land ownership and use. Such conflicts both reduce current income-generating activities as well as discourage investment. While this would seem to demand standard BER, recent literature argues that for some contexts near-term reform should strengthen informal customary

arrangements on land ownership and use rather than incurring the expense and time of a formal cadastre. This approach would likely give greater power to lower levels of government. To what degree should BER encourage decentralization given that sub-national governments have even weaker institutional capacity than the central government? Concerning the sectors having significant numbers of microenterprises (transport, textiles, mining, street operators), to what extent should the policy of stricter regulatory enforcement (supply-side policy) be substituted or complemented by OSH information campaigns and by proactive organizing of informals into legally recognized associations (demand-side policy)?<sup>5</sup>

*BER impact on economic growth and poverty.* There seems to be an emerging agreement in the BEWG that formality itself should not be the objective of BER but economic growth and poverty alleviation. If this is the case then is a two-track approach required?<sup>6</sup> One track would place a greater emphasis on social protections and ensuring that simpler versions of formal services reach the poor, that is, focus more on the benefits side of the ledger; the other track would pursue more standard BER (which the adjustments implied by the recommendations in this report), that is, focus more on reducing the costs of formality so as to address the quasi-formal enterprises and unofficial but dynamic smaller SMEs. If such a two-track approach is taken, is it affordable?

While research has demonstrated that BER can reduce informality, neither the link nor the direction of causality between informality and economic growth and poverty alleviation has been proven empirically—though theory and much circumstantial experience suggest they are linked.<sup>7</sup> Of course at some level scholars believe there is causal link, only that it is rather complex (depending *inter alia* on income level, culture, economic structure, policy mix, quality of infrastructure) and, in principle, very hard to rigorous pin down econometrically.<sup>8</sup> The strength in the short- and long-run and even sign of the correlation of the relationship are not constant over time.<sup>9</sup> Moreover, comprehensive and cross-country-compatible data on the IE for such analysis are lacking.<sup>10</sup> Might the BEWG want to fund a study to macro-econometrically test the conditions under which economic growth and changes in the size of the IE are causally related?

*How donors can support BER that reduces barriers to formality.* Since some areas of potential support are implicit in the issues raised in this section above, they are not

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<sup>5</sup> See Dyce (2006) DCED paper for details.

<sup>6</sup> OECD (2006) also recommends this two-track approach.

<sup>7</sup> See OECD (2006), USAID (2005; p. 4), Welsh (2005)'s DCED Cairo Conference paper.

<sup>8</sup> See OECD (2006) for a more detailed explanation of this conundrum.

<sup>9</sup> In the TRES, Eilat and Zinnes (2002) found the IE and economic growth to swing from pro-cyclic to counter-cyclic, depending on whether economic growth was increasing or decreasing.

<sup>10</sup> One happy exception is Ingram *et al.* (2007).

repeated here. Among the diverse issues to consider include considering the scope for several initiatives raised in the text. First, what is the scope for creating templates for BER-oriented development strategies, plans, and multilateral funding mechanisms? Second, what is the scope for increasing the use of strategic communication and information campaigns to expedite changes in preferences and increase the level of knowledge-based decision making? These approaches can also be used to raise the empowerment of women in business. A related strategy here is to increase empowerment through the support of peer group and community organizations as well as trade associations.

Next, there seems to be a possible inconsistency in the DCED papers taken as a whole. On the one hand they urge the use of “international best practice”. On the other hand, they urge donors to “develop the most efficient and realistic solutions.” The problem here is that the latter requires some experimentation through pilots, while the former focuses on tried-and-true past interventions. Resolving this friction is further impeded because the institutional incentives within the donor agencies themselves have not historically been conducive to much premeditated innovation. Thus, this raises the question as to whether some “BER” might be appropriate taking place *within* the donor organizations so that some experimentation is deemed acceptable. A solution here is to reward some level of responsible risk taking by donor staff. For example, if an innovation is introduced into an otherwise accepted best practice and it is implemented first as a pilot using rigorous prospective evaluation, then even if unsuccessful, concrete learning has occurred that can benefit all donors’ interventions in that area.

This report has argued that a crusade to register all informal businesses and enforce their regulatory and fiscal compliance is unlikely to be cost-effective or even desirable, assuming it were feasible. The underlying regulatory, administrative, and fiscal institutions must first warrant the faith that enterprises would need to have in them. In short, forcing informals to formalize when formal institutions are dysfunctional and corrupt is a recipe to make them even more inefficient and impoverished.

Instead, what scope is there to augment standard BER with legal reforms that lead to economic empowerment of the poor? Economically empowering those in the IE would lead them to increase their economic activity and take advantage of their varied assets to invest in income generating activities. This would increase their economic stake in the system and in turn lead them to incrementally—and voluntarily—increase their participation in the various dimensions of formality they deem necessary as they seek out ways to protect their gains and expand their opportunities. As discussed in Section 2.1.4, the result would be “aphasic formalization”.

This alternative strategy would also offer a country some additional convergent pathways to full formality by allowing it to build upon its rich landscape of

customary and traditional methods of governance (appropriately strengthened with donor assistance) as an intermediate adaptive step. A focus on reducing informality *per se* would prevent such context-driven reform, and the legitimacy it confers. Of course, this approach is not without its dangers since these original methods of governance did not evolve to promote impersonal exchange, the motor of modern markets. Likewise, the question remains on how standard BER should be modified to ensure fair commercial transactions between informal enterprises and formal firms under such a two-tiered system.

*Appropriate institutions for donors.* What is the scope for multi-donor-financed development funds as a source of supporting a long-term BER path?

Perhaps the most difficult challenge for a donor is self-reform. This report argues that many of the innovations required to reach an optimal level of informality require experimentation. This is doubly so because the diversity of countries and subgroups of informality make an effective one-size-fits-all approach to BER unachievable.

This paper has underscored the importance of involving civil society for successful BER. Yet how does one empower the civil society organizations to become partners in reform, raising reform's legitimacy, without making them dependent on donor funding, which reduces their local legitimacy? Similarly, how does a donor disburse directly to local NGOs when the government sees itself as the counterpart?

## 4.2 Outstanding Opportunities

Broadly, this paper mirrors the OECD and recommends a two-track IE approach: improve livelihoods within the IE and encourage formalization.<sup>11</sup> As is now clear, most of the outstanding issues just described simultaneously point to opportunities for further policy analysis, project redesign, or field pilots. These include designing BERs (i) not just to address *areas* of informality but also to target subgroups of informality; (ii) to influence the informality decision by expanding the benefits side—including elements in support of social protection; and (iii) to collect and analyze more survey data (especially across countries) by subgroup, gender, and location. In addition to these recurrent themes, there are other opportunities that merit highlighting since they have great potential for future BER effectiveness.

*Harnessing inter-jurisdictional competition.* This report has advocated a strategy of creating broad-based constituencies for BER through dissemination of information, training, and empowerment of peer groups. This permits intervention designers to draw on the enhanced local knowledge of the beneficiaries and to enhance the

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<sup>11</sup> OECD (2006; 31). Chapter 1 of this source also contains a good list of concrete actions to remove barriers to formalization.

legitimacy of BER. This strategy can be made yet more successful by embedding it into a class of aid delivery mechanisms that harness the power of incentives through competitive institutional arrangements.<sup>12</sup> Called prospective inter-jurisdictional competition, this class of incentive designs has shown great potential in stimulating BER.

As understood in the literature, IJC often occurs naturally as municipalities, states, and even countries compete in a tacit, decentralized way to attract business and new citizens with high human or financial capital.<sup>13</sup> Some have feared that such competition creates a “race to the bottom” as regulation and taxes are weakened in an effort to win business. Yet more recently another use of jurisdictional competition—one based on certification—has developed that encourages a “race to the top”. Examples of this sort of competition are those based on the World Bank’s *Doing Business* indicators as well as indicators from Transparency International, and The Heritage Foundation. It is but a small step to imagine organizing such competition more formally into an explicitly designed “game” among SNGs within a country using sub-national BE indicators to identify winners and donor assistance and financing for “prizes”. Here SNGs would voluntarily compete by implementing BER to improve their BE over a predefined time period. The winners would be those whose BE indicators were the highest (or, alternatively, showed the greatest increase).

In fact, there is no need to imagine this innovation. There are dozens of examples already extant, running from simple “certification” programs right through to complex tournaments.<sup>14</sup> The World Bank has organized tournaments among (sets of fifteen) regions in Russia, villages in Senegal, and *kecamatan*s in Indonesia. USAID has organized these among municipalities in Romania and municipalities in Honduras. It is also used in public finance by governments in the guise of revenue sharing performance-based grant systems.<sup>15</sup> Perhaps the most famous, albeit at the country level, is the Millennium Challenge Corporation’s (MCC) competition for “eligibility”. Here, winners—of which there are many—receive hundreds of millions of dollars for projects of their choice.

It is easy to see why these applications have been successful. Not only do they galvanize local interest and energy to exercise new BER, but they also serve to allocate development assistance to those who reveal through their actions are able to use it. The result is more effective and sustainable outcomes. These competitions are explicitly designed to stimulate collective action, attenuate elector opportunism, and forge an alignment of incentives among private sector, civil society, and government

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<sup>12</sup> Kikeri, *et al.* (2006) at the DCED Bangkok conference makes a similar recommendation.

<sup>13</sup> See Oates (2002).

<sup>14</sup> An example of a certification is the “Awards for Excellence in Business Reform in Asia”, which the DCED funded. See Zinnes (2009b) for a rich array of case studies (including one analogous to the DCED example) and for a detailed analysis of how they work.

<sup>15</sup> See Steffenson and Larsen (2005).

actors to reduce red tape and improve governance. “Winners” are determined based on scores on a set of purpose-built, “second generation governance indicators”. The mechanism increases the effectiveness of donor assistance by avoiding adverse selection in that only localities that are serious about reform will be willing to bear the costs of participation. Moreover, the competition leads localities to create a consensus among diverse groups to rise above petty interests and engage in real reform to the benefit of all parties. Finally, donor funds are leveraged since a limited amount of rewards stimulates a large number of reforms.

While no type of intervention is without risks, analysis of donor applications using IJC mechanisms has found that the degree of their success critically depends on choosing a design that sets up the right incentives (e.g., those aligned with the BER), developing salient and ungameable indicators of performance, and setting motivating targets (in the case of certification mechanisms).<sup>16</sup> While the literature contains no examples of “horror-story” applications, it does contain examples of ineffective ones primarily due to the use of inadequate (or non-salient) awards or indicators based on pre-competition rather than post-competition scores. Finally, there are examples that some would consider downsides to these approaches. First, these mechanisms are not always appropriate. For example, they should not be used when BER is to be implemented in just one or a few jurisdictions,<sup>17</sup> when it is not possible to construct a level playing field, and where there is no local enthusiasm to “play”. Second, a donor will need time to build up expertise on how to design and implement these. Third, due to the fixed costs of design and the benefits of developing a reputation (the donor as an honest referee/payer and the participants as effective users of the technical assistance provided), in many cases it is cost-effective to run “repeated games”, something that a donor’s programming or budget may not allow. Finally, some donors may feel uncomfortable giving participants such a free hand in reform (just as donors used to feel uncomfortable with market-based mechanisms).

Based on the evident success of this mechanism for stimulating local-level *de jure* BER as well as for its *de facto* implementation, this report urges the BEWG to consider sponsoring the development of a template or model program for using the prospective IJC incentive mechanism to carry out informality-reducing BER.<sup>18</sup> Such templates should first be field tested through a series of pilot applications in perhaps

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<sup>16</sup> Thus, for example, neither the Transparency International corruption indicators nor many of the *Doing Business* indicators would be salient in a SNG or other sub-national IJC since the competing jurisdictions would not be able to affect nation-level scores (or interested in doing so). Again, see Zinnes (2009b) for a full discussion, together with extended case-study examples, of how to design successful IJCs and avoid the pitfalls.

<sup>17</sup> For example, they are inappropriate, if applied in just *one* country, to stimulate changes in national legislation (though the MCC uses them for *cross-country* tournaments to do just that!). Once, promulgated, they are perfect for encouraging the *de facto* implementation of a new law.

<sup>18</sup> Of course, as the examples in Zinnes (2009b) illustrates, prospective IJC designs are equally suitable for standard BER currently implemented by the IFC and others.

three countries. By reducing an application's design costs and by providing informality specific country demonstrations, the availability of such templates would be of great service to donors and reforming-country governments to use to expedite and improve the performance of their BER efforts.

*Mixed business ventures.* Over the last few years practitioners focusing on the “base of the economic pyramid” (BoP) have begun to realize that a particular type of business venture carried out as a collaboration between IE businesses and an (often foreign) formal firm has proven quite successful and, better yet, appears to have much potential.<sup>19</sup> Designed to align the incentives of formal firms seeking profits with those of the recipient community seeking socio-economic benefits, these ventures are based on the principles of “co-creation,” “external participation,” and “patient innovation”, among others.<sup>20</sup> Annex 1 provides an extensive list of examples covering many countries and sectors. As is seen, BoP ventures attack development from the bottom up while BER may be considered a more top-down approach.

In a related vein, practitioners have also observed that consumers typically have less choice in developing countries. “Goods and services targeted at the middle market are missing,” e.g., the poor “can...buy either very expensive, high-quality goods [as] found in rich countries or cheap, low-quality goods...from informal enterprises—often, without full knowledge of the hazards and risks”.<sup>21</sup> According to McKinsey, “[t]he 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.”<sup>22</sup> Mixed BoP ventures have begun to test this market with appropriately developed—and often completely new—products, as Annex 1 illustrates.

Given the success of these novel mixed ventures, not to mention the appeal of harnessing the international private sector as a partner in alleviating poverty, the question is whether such ventures constitute an opportunity for BER and, if so, what role the latter can play to facilitate their formation and sustainability. For example, such ventures often form collaborations with a community NGO and the local government and need to overcome regulatory lacunae in the local business environment, missing infrastructure, and illiterate local labor (whom the investors then often train). Might the DCED develop guidelines on how an existing agency

<sup>19</sup> Prahalad, C. K., and A. Hammond (2002).

<sup>20</sup> According to London (2007) co-creation requires that “those at the BoP [be] active participants in the conceptualization of the business model and the design of any technological solutions,” external participation implies that “the catalyst for a business venture...is external to the current base-of-the-pyramid market environment,” and patient innovation requires that the external investor in “the venture has a long-term orientation and the patience to scale [up only in the long-term in order to start generating a return, if and when]... the business model has demonstrated success”.

<sup>21</sup> Other examples include “super safe pasteurized milk or raw milk, luxurious dwellings or shanties, expensive modern shopping malls or tiny mom-and-pop shops, [and] expensive Western cars or motorcycles and bicycles”. (Farrell 2004).

<sup>22</sup> Op. cit.



within a country (perhaps the one-stop shops, where they exist) can provide support to these collaborations, for example, e.g., by providing special training funds for the participating informals and support to the respective local government to secure regulatory completions, modifications, or exemptions? Based on such guidelines, donors could offer to train staff at the one-stop shops (or other empowered agency) on addressing the special needs of BoP ventures, rather than risking that the agency staff will insist that the informal partners first become formal prior to the collaboration receiving assistance.<sup>23</sup> After all, such ventures by definition create large positive externalities and, by integrating the participating informals into formal market channels, these ventures give the informals a stake in the system and encourage them to *want* to become formal.

*Mainstreaming rigorous project evaluation* Given the lack of clarity with regard to how to handle informality (as confirmed by the list of outstanding issues, above) and the need for greater innovation in tackling it, it is essential that donors undertake concrete efforts to rigorously evaluate their BER activities aimed at reducing informality.<sup>24</sup> Donor experience suggests that rigorous evaluation only adds between 5–10 percent to the cost of a project (with bigger projects being on the lower end). Hence, the DCED should consider encouraging its donor members to add a prospective evaluation component to their BER projects.<sup>25</sup> Rigorous evaluation not only helps a government avoid mistakes and donors to replicate verified successes, but it offers a chance to identify negative as well as positive lessons. This means that interventions lacking successful outcomes need no longer be viewed as “failures”; their evaluation teaches implementers why an intervention based on the best available past information and practice was unsuccessful. Once such benefits are recognized, this should lead to greater experimentation—and, therefore, innovation—by project designers.<sup>26</sup> Finally, generally overlooked in the literature is the positive impact on project designers of having more tangible objectives to achieve and on implementer incentives of knowing that the outcome of their actions will be assessed.<sup>27</sup>

For examples of rigorous evaluation as applied to the IE, two opportunities presented above need to be considered. Given the number of SNGs that would participate, an ideally suited application for RIA would be to test the effectiveness of

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<sup>23</sup> The DCED Cairo Conference also made similar policy recommendations (e.g., Welsh 2005).

<sup>24</sup> This recommendation is supported in principle by the Paris Declaration on Aid Effectiveness (OECD 2005).

<sup>25</sup> By prospective is meant the evaluation objectives and methods are conceived and built into the project during the latter's design phase. Integration of the evaluation generally substantially affects the resulting project design.

<sup>26</sup> Here experimentation is used in the sense of trying out new ideas and approaches, not in the RIA sense of having treatment and control groups.

<sup>27</sup> See Zinnes (2009b) for a discussion of this.

prospective IJC to encourage formalization.<sup>28</sup> This can be done in conjunction with a BER implementation or as a means to stimulate (exercise) informals to take advantage of previous BER efforts. In either case, awards can be issued, say in the form of additional SME services, to those jurisdictions that show the greatest improvement in formalization over an announced period.<sup>29</sup> Likewise, six indicators have been proposed to measure the impact of BoP ventures.<sup>30</sup> These could be used as part of an evaluation of these initiatives.

Due to the large number of BER applications expected in the foreseeable future and the opportunity cost in terms of the benefits of other interventions foregone as a result, the DCED should consider (i) developing guidelines for donors on when a project may be exempted from rigorous M&E, (ii) recommending member agencies to use staff incentives to encourage their project designers to take greater advantage of newly available methodologies,<sup>31</sup> and (iii) funding the writing of a manual to advise BER project designers on what project evaluation techniques are most suitable for each of the types of BERs in their toolkits and should provide examples in each of the informality areas discussed in this paper.

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<sup>28</sup> *Ditto*.

<sup>29</sup> The less level is the playing field (i.e., the greater the variation of jurisdictional informal economy characteristics), the more care that must be exercised in establishing award criteria that stimulate the broadest based participation without creating perverse incentives (e.g., illegally coerced formalization). A simpler formulation would be to run (say) annual competitions in which the best performing SNGs get certified (and national advertisement) as a better place to do business. See the Romania case study in Zinnes (2009b) for details.

<sup>30</sup> London (2007).

<sup>31</sup> This has already begun, with many donors and NGOs alike having sent their staff to MIT's J-PAL laboratory on project evaluation.



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# Annex 1: Examples of BoP Ventures

Case studies prepared for the growing inclusive markets initiative

Case	Description
A to Z Textiles (Tanzania)	Production of long-lasting insecticide-treated bed nets
Amanco (Mexico)	Integrated irrigation solutions for small-scale farmers
Amanz'abantu (South Africa)	Supplying water through smart card technology
ANZ Bank (Fiji)	Mobile financial products and services
Aspen Pharmicare (South Africa)	Manufacturing affordable generic antiretroviral drugs
Association of Private Water Operators (Uganda)	Public-private partnership to provide water in small towns
Barclays' Susu Collectors Initiative (Ghana)	Providing microfinance services through traditional Susu collection
Cashew Production (Guinea)	Partnership aimed at reviving the cashew industry
Celstel (Dem. Rep. Congo)	Mobile communication and mobile banking in a postwar economy
Coco Technologies (Philippines)	Production of geotextiles from coconut husk waste
Construmex (Mexico / United States)	Cash-to-asset remittance transfer services
Danone (Poland)	Affordable and highly nutritious milk porridge for malnourished children
Denmor Garments (Guyana)	Production of high quality garments for export
DTC Tyczyn (Poland)	District telephone cooperative
Edu-Loan (South Africa)	Loans for financing superior studies
Fair Trade Cotton (Mali)	Collaborative platform for sourcing fair trade cotton
Forus Bank (Russia)	Financial services for low-income entrepreneurs
Huatai (China)	Wood-pulp production for paper industry
Integrated Tamale Food Company (Ghana)	Outgrower scheme for sourcing organic mangoes
Juan Valdez (Colombia)	Coffee fair trade chain directly linking producers, businesses and consumers

Case studies prepared for the growing inclusive markets initiative (*continued*)

Case	Description
K-Rep Bank (Kenya)	Microfinance products and services
Lafarge (Indonesia)	Rebuilding cement-based houses and businesses in post-tsunami areas
LYDEC (Morocco)	Supplying water and electricity to shanty towns
Manila Water Company (Philippines)	Connecting low-income households to the piped water system
Mibanco (Peru)	Microfinance products and services
Money Express (Senegal)	Remittance transfer services
M-PESA (Kenya)	Mobile banking services
Mt Plaisir Estate Hotel (Trinidad and Tobago)	Ecotourism-based self-sustaining community
Narayana Hrudayalaya (India)	Affordable cardiac health care
Natura (Brazil)	Production of perfume essences from local vegetal biodiversity
Nedbank and RMB/FirstRand (South Africa)	Financial products targeted at the low-income housing market
New Tirupur Area Development Corp. Ltd. (India)	Water supply to industries, households and slums
PEC Luban (Poland)	Straw-based heat generation
Pesinet (Mali / Senegal)	Early warning method for monitoring children's health
Petstar (Mexico)	Waste management services in poor rural communities
Procter & Gamble (Cross-regions)	Affordable purifier of water sachets
Rajawali (Indonesia)	Business partnership between taxi company and poor drivers
RiteMed (Philippines)	Generic drugs production and distribution
Rural Electrification (Mali)	Rural companies installing and managing electricity generating systems
Sadia (Brazil)	Sustainable swine production through biodigester technology
Sanofi-aventis (Sub-Saharan Africa)	Providing drugs in partnership to fight sleeping sickness
SEKEM (Egypt)	Organic agriculture production coupled with social and cultural activities
SIWA (Egypt)	Ecotourism business based on local community specificities
Smart (Philippines)	Mobile telecom products and services for low-income and overseas communities
Sulabh (India)	Low-cost, clean and innovative sanitation systems
The HealthStore Foundation (Kenya)	Health microfranchises
Tiviski Dairy (Mauritania)	Camel dairy sourcing from nomadic herders
Tsinghua Tongfang (THTF) (China)	Affordable computers for rural users
VidaGás (Mozambique)	Supply of liquefied petroleum gas
Votorantim Celulose e Papel (Brazil)	Eucalyptus plantation for pulp and paper industry

Adapted from UNDP (2008; ix).

**The Donor Committee for Enterprise Development** is a gathering of many of the funding and inter-governmental agencies working for sustainable poverty alleviation through development of “the private sector”—the businesses, small and large, that provide the bulk of employment and prosperity worldwide. It was established informally in 1979, when its first members met at a meeting convened by the World Bank. Until 2005, the Committee was known as the “Committee of Donor Agencies for Small Enterprise Development”.

Sustainable development can only be driven, in the long term, by a dynamic private sector; and external agencies can only contribute to that dynamism if their efforts are coordinated. In the quest for harmonisation and effectiveness, the Committee therefore works on:

- defining best practice in priority themes, in participatory ways;
- disseminating best practice and successful experiences between countries;
- increasing capacity of development practitioners to improve their effectiveness.

This technical focus contributes to realisation of the Paris Declaration on Aid Effectiveness, which aims to ensure that “donors’ actions are more harmonised, transparent and collectively effective”.

In addition, the Committee, through its annual meetings and smaller groups set up to tackle specific issues, provides an opportunity for staff of member agencies to get to know their peers, and expand their networks, in a constructive and positive atmosphere.

For more information, please visit the Committee’s website, at [www.Enterprise-Development.org](http://www.Enterprise-Development.org), and the inter-agency databases that it operates, at [www.Business-Environment.org](http://www.Business-Environment.org) and [www.Value-Chains.org](http://www.Value-Chains.org)



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