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Executive summary

The connections between business environment reform (BER) and informality continues to challenge donor and development agencies. Current research on informality has brought limited knowledge of how to address informality beyond the recognition of well-established correlations. Part of this difficulty lies in the complexity of what the informal economy contains and the wide-ranging influences on its dynamics. This topic is also receiving particular attention when considering the coronavirus (COVID-19) outbreak and its impact on the less resilient economic operators.

This report furthers the understanding of informality and the contribution BER can play in dealing with the contemporary challenges faced in this field. This includes a review of existing evidence on the informal economy and the tools that can be used to reduce vulnerabilities of informal firms and their workers while supporting the transition towards formality. It identifies the new and emerging evidence to help donor and development agencies better understand the dynamic between the business environment and enterprise formality, so they can draw on this when formulating new reform-support programmes.

Key Learnings

High levels of firm informality in developing and emerging economies continue to create challenges for governments and their development partners. Indeed, the informal economy is more prevalent in many developing economies than the formal economy. A large informal economy limits the tax base and makes it harder for governments to provide support to the most vulnerable workers, while limiting the availability of legal protections and access to credit, which restrict business productivity and growth. The response to this is complicated by the many forms informal firms and workers can take—as the terms can overlay many different business and worker profiles. Similarly, informality is not usually the outcome of a single influence or driver. Even in the best of macroeconomic conditions, the transition from informality to formality is slow, limiting the speed of any policy feedback loops. Given its size, the informal economy has an important social dimension for many people, and especially for the poor, as it may be the only income source for many.

The informal economy is highly heterogeneous. Informality is found among economic units (i.e., firms) and workers, each with varying degrees of formality, ranging from complete formality to complete informality and along this spectrum, having formal characteristics along dimensions of legal (e.g., registered, regulatory compliance), fiscal (e.g., tax paying) and labour (e.g., employees, minimum wage) formality. Informal firms can be further categorized by their willingness or capacity to formalize. Different policies can serve diverse types of businesses, and in some cases, policies must recognize that formalization may not be a suitable end state for all in the informal economy.

Women in the informal economy are more often found in the most vulnerable situations, for instance as domestic workers, home-based workers or contributing family workers, than their male
counterparts, increasing their economic vulnerability. Similarly, youth in developing economies often remain in the informal economy due to various reasons including the lack of formal employment opportunities and lack of access to productive resources (ILO, 2014).

On a sector-by-sector basis, the agricultural sector has the highest-level of informal employment, reported by Bonnet et al., (2019) at over 93 per cent. This is followed by industry at 57 per cent and services at 47 percent. Geographic variations also occur around the world as well as within countries, with rural areas tending to have higher rates of informality than urban areas.

**Business environment reform can address informality.** At the aggregate level, investment climate or business environment constraints are significantly associated, either positively or negatively, with the incidence of formality. Thus, BER is an important subject for policymakers to address when targeting informality. However, BER alone is often insufficient to achieve formalization at the scale desired. Programmes and policy interventions with limited impact do not effectively address all limiting factors contributing to informality or, due to the heterogeneity of the informal economy, only a subset of firms is impacted by the reform or intervention. Thus, this paper discusses both BER and complementary programmes that can influence rates of informality and the ability to support the informal economy.

Specific BER that have been studied and shown to reduce formality include:

- **Legal and regulatory reform.** Business entry reforms can increase firm formality and work best when delivered in tandem with other reform measures.

- **Fiscal reform.** Because inappropriate taxation systems have been found to encourage informality, taxation reform is often particularly useful. Enterprises of all sizes tend to fail to comply with the tax system if it is too complex, expensive, opaque, or perceived to be unfair.

- **Labour policy reform.** Labour policy that provides access to support for workers while aligning with the status of the firm (such as number of employees, revenues, etc.) can protect informal workers, helping to bring them into increasingly formal employment, and through a stakeholder-centric policy development process, increase employer compliance that leads to increased firm formality.

- **Financial sector reform.** Many informal firms and workers have limited access to formal banking services. Reforming the legal and regulatory framework of the financial sector can lead to better outcomes for informal firms while also supporting the transition towards formalization.

**Measures to complement business environment reform can further support the informal sector.** Complementary measures can be delivered in tandem to traditional BER to address the challenges faced by informal firms and their workers. Complementary measures can be placed into two themes.

The first theme deals with the instruments that can be used to complement BER to enhance the formalization of informal firms. The objective here is to use BER and any complementary activities to shift informal firms towards formalization. Examples of these types of complementary measures include:
• **Behavioural science.** The behavioural science is increasingly used to support and complement BER and formalization. This recognizes ‘rules of thumb entrepreneurs’, status-quo biases that limit the perceived set of opportunities, and instances of high stress that reduce decision-making ability. The use of behavioural insights to address these biases involve recognizing the mental models of business owners and managers and then designing nudges with these mental models to foster the desired changes.

• **Digital technologies.** The emergence of digital technology in developed and developing economies around the world is changing the way business is done. This offers new opportunities for reformers, policymakers and informal business owners, managers and workers.

• **Trust-building between the public and private sectors.** Some informal firms are informal due to limited trust in the public sector. Efforts such as public-private dialogue can support the development of trust that leads to increased tax compliance, improved policy decisions, etc.

The second theme of complementary measures deals with the use of BER and other instruments to address the immediate needs of informal enterprises and their workers. The objective here is not necessarily push informal firms towards formalization, but to help address the immediate needs of informal enterprises and their workers. Examples include:

• **Social protection.** The lack of social protection is a major contributor to the vulnerability of informal firms and their workers. There are two broad and often interconnected challenges here. The first is for governments to extend access to social protection benefits to reach workers in micro and small enterprises (MSEs), whether formal or informal, to increase their resiliency. The second is to help informal enterprise owners and workers to see the value in contributing to social protection schemes.

• **Innovation.** The promotion of innovation in the informal economy, while an under-studied field, highlights the role the informal economy as a place of innovation, often through necessity. Targeted reforms may support productivity growth and the movement towards formalization through helping firms capture the benefits of their innovation.

• **Human capital development.** Human capital development through lifelong learning strategies and investments in skills for informal economy workers is necessary for real progress to be made towards transitions to formality.

• **Increased business capacity.** Enabling firms to respond to emerging new market opportunities, such as through innovative financial products, engaging with the social and solidarity economy, and targeting reforms at industry clusters can have positive results for informal economy actors.

• **Additional support during COVID-19.** The vulnerabilities of operating in the informal economy, have been amplified through the economic shocks due to the response to COVID-19. The impact of the pandemic has been two-fold. First, informal firms and workers tend to be more vulnerable than their formal counterparts in terms of food insecurity, housing instability, limited access to health care, limited connection to economic stimulus resources, etc. Indeed, in many cases, informal firms and workers are not targeted by social protection measures.
Second, many previously formal firms and workers have been forced into activities that, at least partially, can be considered informal. Responses combining immediate assistance with medium-term supports to move towards formality are a means for long-term productivity.

**Recommendations**

From the above key learnings, a series of policy recommendations are identified and grouped into four categories:

1. **Focusing BER for firm formalization.**
2. **Complementing programmes for firm formalization.**
3. **Reforms to deal with the challenges faced by informal firms and workers.**
4. **Reforms resulting from the COVID-19 pandemic.**

Together, the following recommendations support the use of BER that is focused on the informal economy and delivered in tandem with other complementary measures. This includes reforms to promote the transition of informal firms towards formalization, such as through reducing direct and perceived costs of compliance, as well as reforms that aim to address the productivity of informal business owners and their workers.

**Focus BER for firm formalization**

- Explicitly focus reforms on the challenges of the informal economy.
- Assess the diversity of informal business owners and workers and apply a variegated approach.
- Ensure reform packages are comprehensive rather than singular interventions to support formalization.
- Design reforms for supporting both formalization and related policy objectives.
- Apply reforms in a fair, consistent and understandable manner.
- Ensure the inclusivity of women, youth, and other vulnerable groups into all BER development.
- Better regulation is one tool for supporting firm formalization but should not be the only tool used.
- Incentives of various forms and combinations can support formalization.

**Use complementary programmes when developing BER for firm formalization**

- Reform design and implementation can benefit from use of complementary tools.
- Build trust between the government and informal economy through means such as public private dialogue.
- Use behavioural insights to inform reform design and delivery.

**Use reforms to support those in the informal economy**

- Extend social protection to informal firms and their workers.
- Expand support to informal firms who lack the capacity to go formal.
• Develop innovative financial products and services.
• Work with the social and solidarity economy to improve conditions for informal firms and their workers.
• Strengthen industry and sector clusters with informal firms.
• Develop digital solutions to engage with and deliver solutions for informal economy.
• Work with informal sector to support incremental innovations.

Provide supports to the informal economic units in response to the COVID-19 pandemic

• Provide immediate assistance to both informal firms and workers to better respond and adjust to the ‘new normal’ of variants and economic aftershocks experienced in different regions and sectors.
• Provide financial investment and human capital investment to informal firms and workers to complement immediate assistance and promote future resiliency and potential future formalization.
Table of contents

EXECUTIVE SUMMARY .......................................................................................................................... 1

  KEY LEARNINGS............................................................................................................................... 1

  RECOMMENDATIONS ....................................................................................................................... IV

TABLE OF CONTENTS ............................................................................................................................ 1

LIST OF TEXT BOXES ............................................................................................................................ 3

LIST OF FIGURES .................................................................................................................................... 3

LIST OF ABBREVIATIONS ....................................................................................................................... 3

1. INTRODUCTION ...................................................................................................................................... 5

  1.1 SUPPORTING BUSINESS ENVIRONMENT REFORMS .................................................................... 6

  1.2 PROMOTING FIRM FORMALIZATION THROUGH BUSINESS ENVIRONMENT REFORM ........................................ 6

  1.3 UNDERSTANDING THE NEW APPROACHES FOR FIRM INFORMALITY ........................................ 7

2. THE INFORMAL ECONOMY ..................................................................................................................... 9

  2.1 INFORMALITY DEFINED .................................................................................................................. 9

  2.2 REGIONAL DIMENSIONS ................................................................................................................. 11

  2.3 GENDER DIMENSIONS .................................................................................................................. 12

  2.4 YOUTH DIMENSIONS AND OTHER VULNERABLE GROUPS .......................................................... 14

  2.5 SECTOR DIMENSIONS ................................................................................................................... 15

3. SUPPORTING FORMALIZATION ............................................................................................................ 17

  3.1 RELATIONSHIP BETWEEN REGULATION AND INFORMALITY ..................................................... 18

  3.2 THEORIES OF THE CAUSES OF INFORMALITY ............................................................................. 19

  3.3 MOTIVATIONS TO FORMALIZE AND THE HETEROGENEITY OF THE INFORMAL ECONOMY .................. 19

4. BUSINESS ENVIRONMENT REFORMS THAT SUPPORT THE TRANSITION TO FORMALITY .............. 23

  4.1 BUSINESS ENTRY REFORM .......................................................................................................... 24

  4.2 TAX POLICIES AND ADMINISTRATION REFORM ............................................................................ 25

  4.3 IMPROVEMENT OF LABOUR LAWS AND ADMINISTRATION SYSTEMS .......................................... 27

  4.4 FINANCIAL SECTOR REFORM ........................................................................................................ 28

  4.5 OTHER LESS EFFECTIVE REFORM AREAS ..................................................................................... 29

    4.5.1 Land titles, registers and administration reform ........................................................................ 29

    4.5.2 Judicial reform ............................................................................................................................ 30

    4.5.3 Intellectual property rights ........................................................................................................ 31

  4.6 OVERALL IMPACT OF REFORMS ON FORMALIZATION ................................................................ 31

5. MEASURES THAT COMPLEMENT BUSINESS ENVIRONMENT REFORMS ........................................... 33

  5.1 COMPLEMENTING REFORMS TO ENHANCE FIRM FORMALIZATION ............................................ 33
## 5.1 Using behavioural insights to inform reform design and delivery

- **5.1.1 Using behavioural insights to inform reform design and delivery** .......................................................... 34
- **5.1.2 Building trust and public private dialogue** ................................................................................................. 35
- **5.1.3 Digital solutions reduce vulnerabilities and support transition to formality** .............................................. 37

## 5.2 Complementing BER to address the immediate needs of informal enterprises and their workers

- **5.2.1 Boosting innovation in the informal economy** ............................................................................................... 39
- **5.2.2 Extending social protection to actors in the informal economy** ................................................................. 40
- **5.2.3 Developing human capital in the informal economy** ..................................................................................... 41
- **5.2.4 Promoting enterprise development in the informal economy** ..................................................................... 42

## 5.3 Responding to COVID-19

- **5.3 Responding to COVID-19** .............................................................................................................................. 46

## 6. Policy Recommendations

- **6.1 Focus BER for firm formalization** .................................................................................................................. 50
- **6.2 Use complementary programmes when developing BER reforms for firm formalization** ...................... 52
- **6.3 Use reforms to support those in the informal economy** ............................................................................. 53
- **6.4 Provide supports to the informal economy in response to the COVID-19 pandemic** ............................. 54

## 7. Bibliography

- **7. Bibliography** ....................................................................................................................................................... 56
List of text boxes

Box 1: Case Study: Impact of one-stop registration in Mexico 24
Box 2: Case Study: Simples National in Brazil 26
Box 3: Case Study: Bulgaria’s Campaign - Come into the Light 35
Box 4: Case Study: Business registration and trust in Serbia 37
Box 5: Senegal tanners 43
Box 6: Uganda Shoe-Shiners Cooperative Society 43
Box 7: Case Study: Profile and Functions of Kumasi Informal Bakers’ Association 44
Box 8: Clusters and the social economy as a tool in the COVID-19 response 46
Box 9: Case studies: COVID-19 impacts 47
Box 10: Examples of COVID responses 48

List of figures

Figure 1: The size of the informal economy by region 5
Figure 2: Informality as a percentage of GDP in Advanced and Emerging/Developing Economies (DGE-based informal activity) 17
Figure 3: Classifying Businesses by Their Willingness and Capacity to Formalize 21
Figure 4: Contributing Factors Influencing a Business’s Decision and Ability to Formalize 22

List of abbreviations

BER Business environment reform
COVID-19 Coronavirus
CUTS Consumer Unity and Trusts Society
DCED Donor Committee for Enterprise Development
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>EAP</td>
<td>East Asia Pacific</td>
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<tr>
<td>ECA</td>
<td>Europe and Central Asia</td>
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<td>EMDE</td>
<td>Emerging market and developing economies</td>
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<tr>
<td>FAO</td>
<td>Food and Agriculture Organization of the United Nations</td>
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<td>G2B</td>
<td>Government-to-business</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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<td>ILC</td>
<td>International Labour Conference</td>
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<td>ILO</td>
<td>International Labour Organisation</td>
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<tr>
<td>LAC</td>
<td>Latin America and Caribbean</td>
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<td>MNA</td>
<td>Middle East and North Africa</td>
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<tr>
<td>MSMEs</td>
<td>Micro, small and medium-sized enterprises</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>OHADA</td>
<td>Organisation pour l’harmonisation en Afrique du droit des affaires (French); Organisation for the Harmonisation of Corporate Law in Africa</td>
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<tr>
<td>PPD</td>
<td>Public-private dialogue</td>
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<td>PSD</td>
<td>Private sector development</td>
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<td>SAR</td>
<td>South Asia Region</td>
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<td>SEWA</td>
<td>Self Employed Women’s Association (India)</td>
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<td>SMEs</td>
<td>Small and medium-sized enterprises</td>
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<tr>
<td>SSA</td>
<td>Sub-Saharan Africa</td>
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<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
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<td>USAID</td>
<td>United States Agency for International Development</td>
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<td>WIEGO</td>
<td>Women in Informal Employment: Globalizing and Organizing</td>
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1. Introduction

High levels of firm informality in developing and emerging economies continue to create challenges for governments and their development partners. Once seen as the result primarily of a poor business environment, the persistence and, in some cases, growth of the informal economy despite general improvements to the business environment have challenged policymakers, regulators and development partners.

The informal economy encompasses businesses, workers and economic activities operating outside the legal and regulatory systems (Loayza 2016). The scale of the informal economy emerging and developing economies accounts for 25 to 40 per cent of Gross Domestic Product (GDP) and often more than 60 percent of employment (World Bank 2020; See Figure 1). The agricultural sector has the highest level of informal employment, estimated by the ILO (2018) at more than 90 per cent. The World Development Report 2019 describes how, in many developing countries, many workers remain in low-productivity jobs. Indeed, informality ‘has remained high over the last two decades despite improvements in the business regulatory environment’ (World Bank 2019). Indeed, the informal economy is more prevalent in many developing economies than the formal economy. The ILO (2018) reports that more than 60 per cent of the world’s employed population earn their livelihoods in the informal economy; and eight out of ten economic units are informal. Informality exists in all countries regardless of the level of socio-economic development, although it is more prevalent in developing countries. Indeed, two billion of the world’s employed population make their living in the informal economy and are deprived of decent working conditions (ILO 2020).

![Figure 1: The size of the informal economy by region](source: Elgin et al., 2021)

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1 The figure is higher in regions such as Sub-Saharan Africa where when agriculture is included, the informal share of the economy can be upwards of 90 per cent. (Schneider 2015)
As a result, the informal economy merits attention, and the impact of coronavirus (COVID-19)-influenced economic and health disruptions only furthers the importance of the subject as once formal firms and workers are pushed into informal activities. Because of the interplay that exists between the formal and informal economies of many countries, any consideration of business environment dynamics needs to incorporate the concerns of the informal economy as much as the formal economy. A large informal economy limits the tax base and for governments, makes it harder to provide support to the most vulnerable workers and limits availability of legal protections and access to credit, which restrict business productivity and growth (Bussolo et al., 2020). It also limits opportunities to enhance social cohesion and decent work.

1.1 Supporting business environment reforms

The Donor Committee for Enterprise Development (DCED) has paid considerable attention to how donor and development agencies can support business environment reforms that improve the conditions for private sector development in developing and emerging economies. In 2008, the DCED produced guidelines on business environment reform, entitled Supporting Business Environment Reforms: Practical Guidance for Development Agencies. These guidelines, hereafter referred to as the DCED Donor Guidance, established a commonly agreed definition of the business environment and set of objectives that justify donor and development agencies’ support for reform. A healthy business environment was described as essential for growth and poverty reduction. Moreover, business environment reform is needed because, among other reasons, inappropriate regulation, excessive taxation, lack of fair competition, lack of voice, etc., can ‘force many businesses to operate in the informal economy’. As a result, ‘improvements to the business environment can contribute to reducing the size of the informal economy.’ Thus,

‘development agencies should support initiatives that examine the effect the business environment has on the informal economy and the rights of those who work there (e.g., identifying barriers that prevent informal enterprises from graduating to the formal economy and identifying the incentives for formality and informality) and how this varies between women and men’ (DCED 2008; 10).

Yet, the DCED Donor Guidance recognises that business environment reform is not the only response required to the problem of informality:

‘Because informal firms often experience substantial deficits in terms of skills, access to information and access to finance, they can be less able to enjoy the benefits of an improved business environment. Thus, private sector development programmes that address the concerns of the informal economy should include activities that help these firms to be better able to respond to emerging market-driven opportunities’ (DCED 2008; 10).

1.2 Promoting firm formalization through business environment reform

In 2011, the DCED published its first annex to the 2008 Donor Guidance. This annex, entitled, How Business Environment Reform Can Promote Formalisation, hereafter referred to as the DCED (2011...
Annex, recognised that while the formalization of informal firms was desirable for governments and development partners alike, formalization is not the only objective of business environment reform. ‘Because informal economic activity can promote innovation and can act as a buffer to economic shocks that developing economies regularly face, an additional objective of business environment reform is to improve the conditions in which informal actors operate (DCED 2011; 2). This may include making it safer to do business, protecting the vulnerable and encouraging social equality. A dynamic, competitive, and growing economy shows a movement towards formality.

The breadth of causes for informality were identified in the 2011 Annex:

1. Poor general business environment.
2. Few incentives to formalize and poor government services.
3. Exclusion and marginalization of specific social groups (e.g., women, indigenous peoples).
4. Informality due to conflict and other forms of social disruption.
5. Reducing costs and maximizing benefits.

As a result, BER initiatives can complement other initiatives. For example, reforms can enhance business productivity, reduce firm and worker vulnerabilities, promote innovations in the informal sector, and support transitions to formality.

In 2020, COVID-19 pandemic effected the size and nature of the informal economy in many countries, although the full effect of the pandemic is yet to be determined. While external shocks and persistent vulnerability are not new drivers of informality, COVID-19 has created a health, economic and social crisis that has affected hundreds of millions of workers, including business owners (ILO 2020).

Indeed, the pandemic has not been equal in its effects. The most represented sectors and sub-sectors in the informal economy have also been those most directly impacted by COVID-19.

### 1.3 Understanding the new approaches for firm informality

The issue of BER and firm formality continues to challenge policymakers, donor and development organizations. Novel approaches are being applied to support the formalization of informal firms, while new evidence is emerging along with lessons for reformers. This report seeks to identify the new and emerging evidence in this field to help donor and development partners better understand

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2 It is interesting to note that some writers, such as Neuwirth (2011) highlight the positive contribution the informal economy makes to our society.

3 ILO (2020) *Rapid assessment of the impact of COVID-19 on enterprises and workers in the informal economy in developing and emerging countries; Guidelines*, 28 April, ILO website

4 Heavily impacted sectors are notably the wholesale and retail trade sector, including street vendors and other traders without a fixed location. The crisis has also affected small crafts producers in the clothing, leather and carpentry sectors, transport workers and associated activities such as car mechanics, workers in personal services including catering, hairdressing and beauty salons, but also the numerous domestic workers and many more. So, too, have agriculture enterprises and workers been affected, with millions of small peasants from rural or peri-urban areas producing for the urban market being unable to sell their produce (ILO 2020).
the dynamic between the business environment and enterprise formality, and to draw on this when formulating new reform-support programmes.

Based on the review of available evidence, this report provides answers to the following questions:

1. To what extent have reforms that seek to transition enterprises to formality been achieved? Are there gender and age disparities in the evidence? What are the lessons learned?
2. What regulatory measures contribute to businesses remaining informal and other potential negative effects of broader business environment reforms?
3. What reforms encourage businesses to formally register and comply with licensing and other formal requirements (e.g., simplified or intermediary legal status)?
4. Are there good examples of programme interventions that complement business environment reforms (e.g., access to social, financial and technical services for formalising firms as well as access to social protection, training and government services) that may be used to provide incentives to formalization?
5. Are there innovative financial products and instruments that can be directed towards the informal economy, besides credit cooperatives and microfinance products?
6. Is there a role for cooperatives and clusters in responding to the challenges faced in the informal economy and linking formal-informal businesses?
7. Are there good examples of how informal units can be included in formal public-private dialogue (PPD) processes and does PPD play a role in incentivizing firms to formalize by increasing trust in government-to-business (G2B) services?
8. In what areas has COVID-19 affected informality and, as a result, what are the kind of reforms required to address the challenges faced in the informal economy?
2. The informal economy

2.1 Informality defined

There are a variety of ways in which the terms ‘informal economy’, ‘informal sector’ and ‘informal enterprise’ can be defined.\(^5\) While this report will not survey all these variations, it will establish a basis on which these terms are applied in the discussion that follows.

Our understanding of, and response to, the informal economy has changed significantly since the original concept of an ‘informal sector’ was coined in 1972 (see ILO 1972). Then, the term was used to describe the activities of poor working women and men who were not recognised, recorded, protected, or regulated by public authorities. This drew the attention of international development and donor agencies, as well as developing-country governments as to whether informal employment was to be encouraged and whether this should accompany policy and programme interventions that progressively eliminated the worst aspects of exploitation and inhuman working conditions by attacking the underlying causes and not just the symptoms of informality (ILO 1991).

In 2002, the International Labour Conference (ILC) adopted the more encompassing and descriptive term of ‘informal economy’ to refer to all economic activities (i.e., not just ‘economic units’ or firms) that are not covered or insufficiently covered by formal arrangements, either in law or in practice and that are not illicit. Informal economic activities operate outside the formal reach of the law where the law is not applied or enforced, or where the law discourages compliance because it is inappropriate, burdensome, or imposes excessive costs. The ILC (2002) stressed that the main policy objective in addressing the informal economy should be to bring ‘marginalised workers and economic units into the economic and social mainstream, thereby reducing their vulnerability and exclusion.’

Within the above setting, the definition of an informal firm, enterprise or unit becomes a little more difficult. For example, does informality suggest the complete lack of any or all licenses, or only some? Can community enterprises and cooperatives be included in the definition of an economic unit? Does this concept include state-owned enterprises? Does it include own-account workers, domestic workers, and street-sellers? The ILC (2015) defined an economic unit as a unit of economic activity in which hired labour is employed or which are owned by individuals working on their own account, either alone or with the help of contributing family workers or which are cooperatives and social and solidarity economy units.\(^6\)

This report also notes three dimensions of informality that can be placed on a spectrum: legal, fiscal and labour. These are not mutually exclusive categories. The legal dimension refers the level of compliance with the legal and regulatory framework (e.g., the requirements for registration, licenses, permits). The fiscal dimension refers to the financial obligations of the firm (e.g., tax payments, bank accounts, bookkeeping). The labour dimension refers to the obligations associated with employing

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\(^5\) For example, see Zinnes (2009).

staff (e.g., registering staff, employment contracts, social security provisions, minimum wage). Businesses and own-account workers may comply with some but not all these aspects. They may therefore be in various positions of formality or informality across any or all these dimensions and may cycle in and out of informality. As a result, the term ‘informal firm’ or ‘informal worker’ can overlay many different business and worker profiles.\(^7\)

The dimensions of informality can be further disaggregated by accounting for the extent to which specific activities within the business are informal versus formal. For example, a business may be registered but not in compliance with regulations that apply to a certain component of the business, both aspects that fall under the legal formality dimension. As a result, each dimension of informality does not have a dichotomous formal versus informal demarcation. Rather, the spectrum stretches from at one extreme, in which a firm or unit is not registered with any government agency and has none of the required licences or permits. It is, however, recognised that this situation is rare. Many informal firms will have some kind of official permit, most likely administered by a local government authority. However, recently created informal firms and those, for example, selling goods at traffic lights or those that are extremely mobile, may indeed be able to avoid even this (see Chen, et al, 2002; Maldonado, et al., 1999; Reinecke and White, 2004). It is important to note that this firm is not operating illegally or in any criminal manner (e.g., selling drugs, arms or any other illegal product or service). Its informal status suggests it is operating semi-legally, extra-legally or, as some have described, in the shadow economy.\(^8\)

At the other extreme, is the firm that is fully registered with all relevant government authorities, and entirely compliant and up to date with all licenses and permits required to operate. This is what might be described as a ‘formal enterprise’. However, it should be noted that, as highlighted by the ILC’s 2002 considerations of the informal economy, many formal firms may fall short of complete compliance from time to time. For example, the fully registered and licenced firm that is late in submitting its tax report or that pays casual workers cash-in-hand when things are busy. Even in many formal firms, a large proportion of employment consists of informal workers. In Bangladesh and Pakistan for example, informal workers are the majority within formal firms (Bussolo et al., 2020). Thus, even what may be considered a ‘formal’ firm can act in an informal manner.

While the objective of firm formalization will be discussed later, formalization involves the movement, or transition, from one extreme (i.e., no compliance whatsoever) to the other (i.e., full

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7 Informality can be viewed via distinct techniques (theoretical, as well as mathematical that are adopted to measure informality) such as with respect to a ratio of GDP, employment rates, number of businesses, size of businesses, etc. Measurement of informality in macroeconomic literature often is built from survey-based or model-based estimates. Both have their limitations, with surveys facing poor data and biases, while models often rely on large assumptions (Ohnsorge and Yu, 2021).

8 Buehn and Schneider (2009) describe the shadow economy as all market-based legal production of goods and services that are deliberately concealed from public authorities for the following reasons: (1) to avoid payment of income, value added or other taxes; (2) to avoid payment of social security contributions; (3) to avoid having to meet certain legal labour market standards, such as minimum wages, maximum working hours, safety standards, etc; and (4) to avoid complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms.
The precise measures used to quantify this transition at the national level are determined by the number and type of agencies and their specific legal and regulatory requirements that firms are required to comply with (e.g., licenses, permits and administration processes). Formalization seeks to make compliance easier and more attractive.

Because of the broad range of possible definitions and types of informality that arise, many researchers and development agencies focus on specific characteristics of informal enterprises. This helps to contextualise the concept of informality by paying more attention to the drivers of informality and the types of firms that are considered. For example, de Paula and Scheinkman (2007) narrow their analysis of reforms in the informal sector by those firms that avoid paying tax.

2.2 Regional dimensions

While informality describes a range of dimensions, these typically arise from varied reasons. Informality is not usually the outcome of a single influence or driver. OECD and ILO (2019) find distinct patterns in vulnerability in the informal economy across and within countries. Thus, they argue that tackling vulnerability in the informal economy needs to take these differences into account.

In Europe, the OECD (2015) suggests that informality is affected by macroeconomic conditions. Where periods of economic expansion are associated with ebbing informality, moments of economic slowdown led to growing informality. However, institutional factors also matter: high taxation, burdensome business regulations and lack of deterrence are all important drivers of informality. In the Western Balkans, the World Bank Group (2021) reports that ‘hidden employment’ (i.e., labour informality) is particularly high. Moreover, several key factors are found to be driving informality: regulations and the business environment, taxation, the credibility and quality of institutions, corruption and trust in government service delivery, and lack of deterrence mechanisms, such as inspection.

Zinnes (2009) describes some of the broad variations in regional drivers of informality in developing and emerging economies. For example, in Sub-Saharan Africa (SSA), where job creation needs to exceed five percent to keep up with high fertility, a job, an enterprise and a household are often one and the same, a self-employed individual working from home. For 80 per cent of the population, unemployment is not a coping strategy since survival is at stake. Here a profound lack of skills, credit, investments, and infrastructure may be a more pressing problem than weaknesses in the business environment. This will vary by sub-region, as costs of corruption, limited public-private trust, among other features of the economy will in some cases supersede the immediate needs of enterprises to go formal. In contrast, informality in Latin America and the Caribbean is often typified by the lack of a title to assets, especially land, to obtain financing for commercial activities that creates an obstacle to formality. For the newly industrialized countries of this region, the informal economy is more like an unregulated sector, rather than one comprised of involuntary, disadvantaged, precarious, or underpaid workers. The informal economy is often the main entry point of young uneducated workers into a paid job. In Asia, a greater range of drivers to informality are displayed, with the Indian subcontinent, Southeast Asia and China each having their own characteristics. Zinnes (2009) describes informality as being ‘more institutionalized’ in Asia than in Africa, with the poor work
environment for informal children and women being especially problematic in South Asia. Strong extended family networks often dampen the social costs of informality and the region also boosts lower transaction (indirect) business costs than in other developing countries. Finally, not unlike developing economies, the informal economy in transition economies is often a result of avoiding taxation, regulation and corruption. While these descriptions by Zinnes (2009) are generalizations, they provide a view into leading regional dimensions of informality. These variations noted also predate the shifts since the COVID-19 pandemic that are still being studied. Such shifts include pushing previously formal workers and enterprises into varying degrees of informality as a means of survival.

The other regional dimension often discussed is the difference in rates and dimensions of informality between rural and urban areas. Bonnet et al., (2019) states that approximately 80 per cent of rural labour is informal at the global level as compared to 43.7 per cent of urban labour. This discrepancy is in part a reflection of the dominant industries in rural versus urban environments and the different sizes of businesses (further described in Section 2.4).

2.3 Gender dimensions

An accounting of heterogeneity of informal economy would be incomplete without recognition of the large gender disparities. The ILO (2018) notes that, globally, informal employment is a greater source of employment for men (63.0 per cent) than for women (58.1 per cent). However, in the report, the ILO also says that this may be a result of data disparities where major countries such as China and the Russian Federation, which have many men working in the informal economy, distort the overall pattern. Women in the informal economy are more often found in the most vulnerable situations, for instance as domestic workers, home-based workers or contributing family workers, than their male counterparts.

Various studies note the prominence of women in the informal economy due to reduced economic opportunities as well as the large impact felt by the COVID-19 crisis. Mukhtarova (2020) notes that in Sub-Saharan Africa and South Asia, over 70 per cent of female employment is in the informal sector—not including the agricultural sector where it is over 90 per cent. More broadly, in lower income countries, women’s rates of informal employment are higher than men’s, making their incomes more vulnerable to external shocks such as COVID-19. For example, Mukhtarova (2020) in a household survey from Kenya find that half of women with a job prior to the pandemic were now without a job. Women are also more likely to bear the responsibility of unpaid caregiving in their households (FAO, 2020). Raveendran et al., (2020) note that in India the economic crisis has meant 51 per cent of women with dependents said their childcare burden has increased as well as increased cooking and cleaning responsibilities compared to men.

Furthermore, rural women often make up more than 60 per cent of employment in the agricultural sector in Southeast Asia and Sub-Saharan Africa (ILO, 2019). Disruptions in supply-chain and reduction in consumer demand such as those seen during COVID-19 are likely to most severely impact those women with the least opportunity for alternative means of income or connection to social protections. Mbaye, et al. (2015, 2018) find that women are well represented in informal enterprises in west African cities like Dakar, Ouagadougou and Cotonou, where women are more likely to work...
in informal small enterprises than in formal ones. Similarly, female-managed firms are more consistently excluded from infrastructure services such as water, electricity and telephones, and make less use of information and communications technology.\(^9\)

The benefits of formalization may be greater for women than for men. Chen, et al. (2011) report on the impact of the investment climate on female owned, informal businesses in Gujarat, India. They find that the constraints faced by these businesses are greater than those faced by male run informal businesses (both faced greater constraints than the formal sector). These constraints include access to technology, finance, storage, irrigation and transport infrastructure, as well as poor access to social protection. In particular, high costs of inputs, the seasonal nature of the sector and the lack of formal credit create a ‘cycle of debt’.

Gueye (2020) examined the regulatory environment in Francophone African countries and the OHADA legal system to consider the experience on small, women-led enterprises.\(^10\) In this context, businesses were found to be overrepresented in the informal sector. Thus, female-managed firms were often found to be more vulnerable and in greater need of assistance than their male counterparts. The main preoccupation of government authorities in these countries was ‘just to tax [small, women-led enterprises] more, with little or any effort to provide services and encourage them to formalize through carrots rather than sticks.’ Gueye (2020) propose the use of business incubator and accelerator programmes, through which government, non-government organisations or donors bring together several small firms to provide coaching and various types of support.

Gender-neutral policy does not necessarily equally benefit both men and women. DCED (2016) finds that business registration and licensing ‘is widely acknowledged to be gender neutral.’ However, the evidence suggests these reforms have differential impacts on women and men due to social norms in terms of how these processes are administered. This, says DCED (2016), ‘contributes to women entrepreneurs choosing to operate informally with implications for tax-collection, women’s social protection and business growth.’ Thus, ‘any gender sensitive business environment reform may require addressing more than the direct business environment factors that impact women’s employment and their enterprise.’ This includes providing support to businesswomen to navigate the legal and regulatory procedures and to specifically address problems such as official harassment.

Saha, et al. (2021) examined the impact of the *Pelayanan Terpadu Satu Pintu* or one-stop shop business licensing reform in 2009 on firm performance in Indonesia, and how these impacts vary based on the gender of firm leadership. They found that, on average, firms benefited from improved

\(^9\) Mbaye, et al. (2018) find that the shares of female-managed enterprises in Douala with an email account and a website are only nine per cent and 1.5 per cent in Douala; the corresponding figures for male-managed firms are much higher, at 42 per cent and 26 per cent, respectively. In Yaoundé and Libreville, these shares are a little bit higher, but a significant gap between male- and female-led firms is still observed. A similar pattern emerges for access to infrastructure.

\(^10\) OHADA is the acronym for the French *Organisation pour l’harmonisation en Afrique du droit des affaires*, which translates into English as Organisation for the Harmonisation of Corporate Law in Africa. OHADA aims facilitate and encourage both domestic and foreign investment in the member states, and as most of the participating countries are former French colonies, they draw chiefly on a modernised French legal model to achieve their goals.
business performance (i.e., as measured by sales), as a direct or indirect effect of this reform, as well as an increase in the number of medium and large-scale firms. However, women-led firms were lesser beneficiaries of these reforms than their male counterparts.\(^{11}\)

When examining the effects of formalization on informal trade in Africa, the Food and Agriculture Organization of the United Nations (FAO) and the Consumer Unity and Trusts Society (CUTS) International (2017) suggest that it is generally accepted in Africa that constraints on women, such as limited access to finance, traditional values, gender roles, violence and even health issues, have hindered them from seizing the opportunities provided by the expansion of trade, and in particular the move from informal to formal trade regimes. Thus, it is important to ensure that trade policy and infrastructural constraints to trade are removed in ways that potentially benefits women as it would benefit all other traders in general, especially in countries where women constitute a sizeable percentage of the informal trading network.’

Given the many constraints women face in participating in the formal economy, OECD and ILO (2019) argue that due to the absence of effective, gender-sensitive policies to manage risks, men and women informal workers will remain particularly vulnerable, and vulnerability will continue to be passed on to other segments of the population, particularly children and older individuals, who disproportionately live in households relying fully on the informal economy in developing countries.

Saha et al., (2021) recommend that, if they are to benefit women-led enterprises, BER programmes should ensure services are readily available in rural areas; invest in targeted socialisation efforts to reach growth-oriented businesses led by women or minority business leaders likely to benefit; prioritise business environment measures that are relevant for the informal sector and create the conditions for them to formalize; and couple general business environment improvements with targeted efforts to improve productivity and upgrading in sectors dominated by women.

### 2.4 Youth dimensions and other vulnerable groups

Many of society’s most vulnerable are disproportionately affected by informality in developing economies. Informality is widespread among young workers, affecting three in four young workers worldwide and close to 96 per cent of young workers in SSA and Southern Asia (ILO, 2020d). Informality increases the risks faced by young people in their transition from school to work, potentially limiting their option for formal employment.\(^{12}\) ILO (2021e) reports on research that

\(^{11}\) Outside Jakarta, women-led firms experienced a small but significant benefit relative to male-led firms, related to both sales and the number of medium and large-scale firms they run. In Jakarta, women-led firms continued to lag behind men. There were no significant effects on employment, and this held across province and gender (Saha, et al., 2021).

\(^{12}\) A 2012 study in Argentina, Brazil, Chile and Mexico found that only a small percentage of youth managed to transition from informal to formal employment. The probability of transitioning was least likely in Argentina and Mexico, where the rates were 15% and 10% of young employees, respectively. Although the percentage was also small for these workers in Brazil and Chile, approximately 30% of this group managed to transition to formal wage employment. Transition rates differed between the sexes, generally in favour of women. The rate of transition of
followed several cohorts of young Brazilian workers over time, focusing on those who experienced unemployment or informality at the beginning of their working lives. The study noticed that young workers in early adulthood were more likely to be unemployed or informally employed and had lower average wages.

Globally, indigenous peoples’ opportunities to access good quality employment are scarce. Traditionally, indigenous peoples’ economy was largely based on reciprocity, solidarity, barter, communal work and low levels of monetization. With globalization and rural-urban migration, indigenous peoples now rely mostly on the informal job market to generate income, particularly in the cities. Globally, they are 20 percentage points more likely to work in the informal economy than non-indigenous workers (FAO, 2020b). In Latin America and the Caribbean, indigenous workers are 31.5 percentage points more likely to work in the informal economy than non-indigenous workers. Furthermore, indigenous women are disproportionately dependent on the informal economy to make ends meet, with over 86 per cent of indigenous women globally working in the informal economy (FAO, 2020b). Any BER that includes addressing the vulnerabilities of those in the informal economy must consider the most vulnerable members of the economy and the types of obstacles they face to improve resiliency and well-being.

2.5 Sector dimensions

Rates and dimensions of informality varies by sector. The agricultural sector has the highest-level of informal employment, reported by Bonnet et al., (2019) at over 93 per cent. This is followed by industry at 57 per cent and services at 47 percent. While these are global figures the authors go on to note that when informal employment is the primary source of employment in a country, it tends to be high across all sectors, not just agriculture. Still, this recognition of the high degrees of informality in agriculture are in line with that seen in other studies. Loayza (2007) finds that informality in an economy decreases when the production of the economy shifts away from agriculture, and as the proportion of the population that is youth and rural declines.

While it is beyond to scope of this paper to examine the full range of informality patterns across industry sectors, it is useful to identify variations in these patterns and for reforms to focus on those areas that are of particular concern within industry sectors and sub-sectors. For example, the ILO (2015a) notes that the construction sector is characterized by high levels of informality and non-standard forms of employment, especially in developing economies. It highlights the importance of the adequate protection of workers in the transition to formality, including the adoption of ‘appropriate regulatory frameworks, compliance with and strong enforcement of the law, and


14 The DCED has published some reports on BER in specific sectors and subsector (see DCED 2013, White, 2015; Overseas Development Institute, 2019).
effective social dialogue.’ Another example is the tourism sector. Here, ILO (2020a) suggests informal employment accounts for 40 per cent of total employment in developing economies. However, this is a sector with many sub-sectoral variations that appears to influence the patterns of informality, both among informal firms and informal workers. Lv (2020) reviews annual panel data from 2000 to 2007 across 96 countries and finds that an increase in tourism decreases the informal economy if the level of tourism development is low, and, in contrast, increases the informal economy if the tourism development level is too high. Informality can appear different by sector, by the level of development of the sector, as well by the level of development and diversification of the economy.
3. Supporting formalization

The transition of an economy from informality to formality, in the best of macroeconomic conditions, is slow (see Figure 2). This slow movement is driven by economic growth in the broader economy (Medina and Schneider, 2019). Transitions are even slower in economies with high labour market growth. While improving incomes for the poor in the short-term requires policies that enhance firm productivity in the informal sector, the transition to formality requires a longer timeframe (La Porta and Schleifer, 2014).

Supporting the transition to formalization can occur through multiple complementing policy objectives, from reducing vulnerabilities, improving governance, supporting economic growth, generating tax revenues, and from there, improving the quality of public goods and providing decent work. Depending on the given local conditions the types of complementary policy objectives will have greater or lesser priority and be informed by the different types of informal firms and workers being supported. Necessity and subsistence firms that do not have the capacity to formalize will benefit from supports that reduce vulnerability and strengthen business operations. Firms that have the capacity to formalize would benefit from productivity enhancement, an enabling environment, effective incentives and access to growth opportunities. As a result, for many in the informal economy, improvement of working and living conditions is a necessary first step in a gradual transition. Thus, support should focus on removing obstacles and creating an environment that facilitates and encourages their transition and ultimate formalization (OECD and ILO 2019). Careful segmentation of different categories of workers and enterprises in the informal economy is important.

Governments and other businesses can also have a vested interest in maintaining levels of formality. Informal economic activities create unfair advantages over formal firms (Gonzalez and Lamanna, 2007; Friesen and Wacker, 2013), while reducing public revenue due to unpaid taxes and often using public goods such as roads, sewer systems, etc. Reduced public revenue reduces government capacity to provide social protection programmes and robust public services. Indeed above-median
rates of informality are associated with reduced government revenues as a proportion of GDP (Ohnsorge and Yu, 2021).

That said, the informal economy has an important social dimension for many people, and especially for the poor, as it may be the only income source for many. The OECD (2009) notes the informal economy, given its size and persistence, cannot necessarily be considered wholly good or bad. Some amount of informality is likely to always remain. The question then becomes the extent to which policy should accept or support the informal economy or attempt to reduce its size. While both policy routes are needed, determining the shape of this policy and how they may be interconnected is an area of ongoing study. Further, policy makers must consider potential unintended side-effects, minimizing for example the risk of reducing informal employment that is not transitioning to formal employment (IOE 2021).

Factors that lead to informality may include:

- Low business productivity, poor general business environment;
- Few incentives to formalize, such as access to new markets, ability to attract investment, etc.;
- Poor government services (i.e., many informal enterprises associate formalization with high regulatory burdens and harassment);
- Exclusion and marginalization of vulnerable groups;
- Conflict and other forms of social disruption,
- Avoiding or reducing costs; and
- Corruption and poor governance which reduce trust and create high hurdles to compliance.

Many informal business owners trade off the costs of formalization with the benefits (DCED, 2011).

This understanding helps to realize that regulation alone, while important and a source of informality, is not the sole driver of informality. There are other factors in society that support its continuation (Chatterjee and Kanbur, 2014). As a result, this paper discusses both BER and complementary programmes that can influence rates of informality and the ability to support the informal economy.

### 3.1 Relationship between regulation and informality

At the aggregate level, every investment climate constraint is significantly associated, either positively or negatively, with the incidence of formality (Ingram, et al., 2007). For example, more firms are in the formal sector where electricity, access to finance and access to land are perceived to be less constraining. Similarly, Loayza (2007) finds that informality decreases when law and order, business regulatory freedom or schooling achievement rise. These explanatory variables are used to understand informality. Each retain their significance after controlling for the others and, as a result, the role of the business environment and investment climate on informality can vary (Loayza, 2007).

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15 Ohnsorge and Yu (2021) suggest this may range from five to 12 percentage points.
Klapper, et al. (2007) report that business entry and density rates are significantly related to country-level indicators of economic development and growth, the quality of the legal and regulatory environment, ease of access to finance, and the prevalence of informality.

Moreover, Dau and Cuervo-Cazurra (2014) find that economic liberalization positively affects formal and informal entrepreneurship, while governance levels have a positive impact on formal entrepreneurship but a negative effect on informal entrepreneurship.

These results have policy implications. Through business environment reforms, policymakers may be able to reduce the burden of formality and provide an incentive for informal firms to transition to the formal economy (Ingram et al., 2007).

3.2 Theories of the causes of informality

A common issue raised concerns the extent to which firms are interested in formalizing and why informality arises in the first place. Here theories of informality guide the approach to supporting the transition to informality. Theories include:

- **Exclusion view.** Businesses are ‘excluded’ from the formal economy due to high entry costs (De Soto 2003; Friedman, et al., 2000; Floridi, et al., 2016).

- **Exit view.** Businesses ‘exit’ the formal economy after assessing costs and benefits of formalization. This may also be termed the voluntarist view, which notes that businesses voluntarily choose to be informal (Maloney 2004). A sub-set of this view is the ‘parasite view’ whereby businesses intentionally stay small and informal to avoid detection by authorities (Porta and Schleifer, 2008). This can create negative impacts, as Amin and Okou (2020) in their study find that informal firms lower the productivity of formal firms by 20 to 24 per cent.

- **Dual Economy or Dualist view:** This view states that there are not enough jobs in the formal economy, so the informal economy is needed for overflow workers and their small businesses (Porta and Shleifer, 2008; USAID 2005). This is also termed the survivalist or subsistence view.

- **Structuralist view.** A cross-cutting view, the structuralists consider the informal economy to be a subordinate complement to the formal economy (Portes and Haller, 2010; Basile and Cecchi, 2001; Portes and Schauffler, 1993). The informal economy provides the formal economy low-cost inputs and flexibility from operating unregulated.

3.3 Motivations to formalize and the heterogeneity of the informal economy

The many theories associated with the informal economy highlight its heterogeneity and the varying views on the motivations of enterprise owners to formalize. Indeed, part of understanding the variability of factors of formality and the mixed results experienced by formalization efforts is tied to the heterogeneity of the informal businesses themselves (Berner et al., 2012; Floridi, et al., 2016, 2019; Williams and Shahid, 2016). Firm decisions to register or obtain the relevant licenses and permits, and make the payments required to comply are made on the basis of a cost-benefit analysis. Owners and managers consider whether the benefits of informality or formality outweigh the costs (Djankov, et al., 2002; Loayza, 1996; Ishengoma and Kappel, 2006). This is complicated by findings
that the benefits of formalization are not always readily realized. An impact evaluation conducted in Benin found that businesses motivated to formalize by a combination of government incentives (structured to ease the costs of formalizing), did not appear to benefit much from their formal status for the first two years. While they accessed more business training and paid lower taxes, they were not more likely to have business bank accounts, gain new customers, have higher profits or sales, or hire additional workers (Benhassine, et al., 2016). Thus, incentives may only be an effective means of formalization if the problems they are designed to counter are well defined and the incentives are considered meaningful to informal business owners. This may require not only reducing costs of formalizing but also raising the benefits of formalizing through financial gains.

Often, motivations to formalize focus on whether informal firms are ‘growth oriented’ or whether they are simply operating because they have no other employment or survival options. For example, the conceptual framework used by the Global Entrepreneurship Monitor focuses on the businessperson’s motivation for starting a business, which it describes as necessity-driven or opportunity-driven. Necessity-driven entrepreneurs are forced to start a new business in order to survive in the face of unemployment or poor alternative work opportunities, whereas opportunity-driven entrepreneurs are attracted to start a new business, leaving their existing employment, to take advantage of a new market opportunity.

This view informs much of the thinking around formalization. It suggests that only those firms that are growth-oriented are likely to take advantage of the increased opportunities that stem from a better business environment. This topic opens the door to considering the motivations behind the decision to start-up and remain informal. As mentioned above, the issue of motivation and how governments can encourage informal firms to formalize remains a critical and challenging issue. However, the dichotomy of ‘necessity-driven’ and ‘opportunity-driven’ appears to be overly simplistic in this regard.

In a further advancement, Stein et al. (2013) note that businesses can be grouped based on their willingness or capacity to formalize. This provides an important framing for understanding how the many different internal and external factors may predispose businesses to take the next step. Figure 3 also notes the types of interventions and supports that may be suited to businesses within each quadrant.

Knox et al. (2019) explored the aspirations of the micro and informal enterprises in the street food sector in South Africa, Rwanda and Senegal and found that the vast majority do indeed aspire to grow their enterprise, despite constraints on investing or growing their business. They argue that the categorical definitions of survivalist versus growth-oriented entrepreneurial logics are ‘potentially damaging or misleading and that assigning such entrepreneurial logics leads policy-makers to discriminate against low profit and livelihood strategies.’ Moreover, they claim that policies that

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17 However, the authors also found it was not possible to determine whether these enterprise owners would opt for better wage employment given the chance. Thus, it was not possible to demonstrate a division between survivalist and growth-oriented entrepreneurial logics as prescribed in the literature.
discriminate against survivalist enterprises in the street food sector inadvertently discriminate against the women who dominate this sector. Their research shows that women ‘derive multiple benefits from working in this sector—none of which make them any less ambitious than men.’ Thus, there is a need to look deeper into the motivations of formalization, rather than simply frame this issue as being either necessity- or opportunity-driven.

Figure 3: Classifying Businesses by Their Willingness and Capacity to Formalize
SOURCE: Stein et al. (2013)

Noting this variety of factors that play into decision regarding formalization, Figure 4 below summarizes some of the major factors discussed in the literature. These factors influence the motivations and perceived costs and benefits of formalization. They also inform the types of reforms and interventions that can be put in the place and serve as a framework to identify any of the gaps in an overall strategy for firm formalization.

Not all the reforms or development initiatives identified in the figure above explicitly target informal firms. Regardless of this, these factors can influence firm formalization. This connects with the earlier point raised regarding the extent to which informality is the direct result of a policy failure or poor business environment, or a lag-indicator reflecting broader issues related to governance, social cohesion, rule of law, and robust safety nets.\(^\text{18}\)

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\(^{18}\) For example, see Loayza (2007).
### Factors Driving Formality

**Business and Entrepreneurial Characteristics**
- Independence (self-efficacy);
- Access to training;
- Profit and growth orientation;
- Socio-economic class and marginalisation;
- Number of employees;
- Capital; Productivity

**Cost of Doing Business**
- Registration and licencing costs;
- Business and occupational regulation;
- Taxation; Property rights; Legal protections and insurance; Harassment by officials; Penalties for failure to comply

**Markets**
- Access to and cost of credit and banking services;
- Access to market linkages and value chains;
- Access to public procurement;
- Competition and cooperation;
- Customer base and advertising;
- Industrialization and economic structure.

**Institutions and Government**
- Rule of law and culture of rule following;
- Enforcement;
- Corruption and bribery;
- Bureaucracy and ease of tax collection;
- Access to information on regulations, banking, etc.;
- Access to public services and social protection;
- Stability; National quality infrastructure;
- Public-private Dialogue;
- Social Security coverage

**Labour**
- Social security for employees and the self-employed;
- Contracts for employees;
- Wages; Skilled versus unskilled; Availability; Taxation.

**Business Culture and Tradition**
- Tax morale;
- Trust in government;
- Trust in other firms to comply;
- Consumer confidence (tax receipts, guarantees, public image, etc.);
- Tradition of doing business;
- Discriminatory practices.

**Objective:**
- Formalization of the Firm
- The surrounding factors influence the formality achieved
- [Legal, Fiscal, Labour]

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**Figure 4: Contributing Factors Influencing a Business’s Decision and Ability to Formalize**

SOURCE: Adapted from Nielsen et al., (2020)
4. Business environment reforms that support the transition to formality

This chapter considers the evidence related to BER that supports the transition from firm informality to formality. As discussed above, BER alone is often insufficient to achieve this outcome at the scale desired (Bruhn and McKenzie, 2018). Thus, this chapter summarizes the current knowledge in this field before moving on, in Chapter 5, to consider the complementary initiatives that can be taken to support the formalization of informal firms.

OECD and ILO (2019) find that the transition to formality of workers and economic units is a complex issue that touches on a wide range of policy domains. This includes laws, regulations and policies that ‘promote the registration and licensing of enterprises with national, provincial and municipal authorities, the creation of enabling business environments, and the enhancement of compliance with legal frameworks, such as tax, social security and labour laws.’

Common subjects for business formalization include (DCED, 2011; Floridi et al., 2019):

1. Business registration and licensing;
2. Taxation policy and administration;
3. Land ownership and titling;
4. Labour and labour related issues;
5. Judicial reform;
6. Intellectual property rights;
7. Financial services;
8. Access to information about business regulation;
9. Incentives to formalize and communicating these to informal enterprises; and
10. Enforcement.

The specific BER interventions and reforms (of points 9 and 10 above) are numerous and take the forms of reducing costs of registration and requirements, providing trainings to entrepreneurs, providing information to workers, facilitating registrations with one-stop shops, increased enforcement, providing tax incentives, social security incentives, creating simplified legal statuses, creating accessible financial funds, among others to be discussed. The specific reform selected is often tailored to the diagnosed issue (e.g., compliance can be enhanced by reducing the amount of compliance required of firms and making it easier, cheaper and more desirable for firms to comply). However, these interventions are often expensive, having mixed results and limited transferability, keeping a widespread programmatic approach to informality out of reach (Bruhn and McKenzie 2014; Floridi, et al., 2019). Programmes and policy interventions with limited impact do not effectively address all limiting factors contributing to informality and/or, due to the heterogeneity of the informal economy only a sub-set of firms is impacted by the reform or intervention.
4.1 Business entry reform

Business entry reforms can increase firm registrations. van Elk and de Kok (2014) suggest that single reforms aiming to increase firm registration by reducing the cost of formalization need to offer a high reduction of registration payment (i.e., at least 50 per cent) to have significant effects on the number of registered businesses. Single reforms aiming at reducing the length of registration procedures can have a significant effect starting from a 15 per cent reduction of the time needed for registration. Moreover, combining several reforms aiming at reducing the cost of formalization perform better and require less drastic reductions. Innovative approaches link the cost reduction of formalization to clear benefits such as easy access to social protection for entrepreneurs and workers of micro-enterprises.

In their review of randomised and non-experimental studies dealing with the causal effect of policies to promote firm formalization, Bruhn and McKenzie (2013) found that efforts to lower the cost of registration and simplify the registration process did not affect small informal enterprises. They suggest that most informal firms are ‘making what is a privately optimal decision’ to remain unregistered. Thus, improving business licensing and registration does not appear to work as a strategy for formalization on its own, at least in terms of the number of businesses registered and licensed. Similarly, Bruhn and McKenzie (2018) again, in a literature review, note that interventions providing information alone or paired with other cost reductions of formalization have limited impact. Similar findings are also reported by Warner (2012), Fajnzylber and Montes-Rojas (2011), Monteiro and Assunção (2012), Bruhn (2011, 2013), de Mel et al., (2012) and Kaplan et.al., (2011).

De Mel et al. (2012) incentivize formalization in Sri Lanka by reimbursing direct costs of registration and find no change in rates of registration. Alternatively, when delivering payments equivalent to up to one month of median firm’s profits, approximately one-fifth of firms registered. Similarly, de Andrade et al. (2013) test the effect of free registration costs for informal firms in Brazil and find no to negative impacts on rates of registration with only inspections leading to increased registration rates. The evidence is cautious around the extent incentives boost registration.

Box 1: Case Study: Impact of one-stop registration in Mexico

The implementation of one-stop registration in Mexico led to 14.9 per cent of informal business owners with characteristics similar to formal business owners (e.g., older, more educated, head of household, etc.) formalizing their businesses, while six per cent of business owners with characteristics similar to wage workers (e.g., younger, less educated, unmarried, etc.) rather than formalize, became wage workers. The individual business characteristics (e.g., number of employees, use of bookkeeping, etc.) was shown to be influential in rates of formalization, although characteristics appear to encompass only a part of the story, as many other comparable businesses did not formalize.

SOURCE: Bruhn (2013)
The International Finance Corporation (IFC 2013; 46) suggest that other efforts are needed to bolster the intended outcomes of business registration and licensing reform: ‘business entry reforms work best when complemented with other investment climate reforms.’ McKenzie and Woodruff (2006), among others, also suggest that costs are not the primary reason businesses don’t formalize, instead arguing that businesses that are too small are unable to take advantage of the benefits of formalization. For example, reducing costs of registration in Portugal led not to registration of high-performing informal businesses but to the registration of less-qualified businesses that were the least likely to reap the potential benefits of formalization and provide tax revenues (Branstetter, et al. 2013).

The ability of informal firms to reap the benefits of formalization varies by context, but is important to consider. Writing in Vietnam, McCaig and Nanowski (2019) find that obtaining a licence is not associated with an increase in profits or other business outcomes such as revenue, expenses, and employment. This suggests that inducing more businesses to register is unlikely to bring about large-scale changes for these businesses. Similarly, writing in Zimbabwe, Mukorera (2019) indicate the willingness or unwillingness of informal entrepreneurs to formalize is significantly related to institutional imperfections and the asymmetry of bureaucracy associated with the registration process, lack of access to technology, market and financial constraints and lack of entrepreneurial and management skills. Thus, while improving the bureaucracy of the registration process and access to technology may possibly increase the odds of the informal operators formalizing their businesses, improvement in market and financial constraints and entrepreneurial and managerial skills will decrease the odds of willingness to formalize.

Olomi and Juma (2018) examine evidence from Ghana, Kenya, Rwanda, and Tanzania and find that a majority of informal businesses are unlikely to transition to the formal sector even when regulations are simplified. Instead, informal businesses are likely to realise the benefits of formalization when encouraged or required to join self-regulated cooperatives or associations. They recommend government authorities would engage more closely with these kinds of organisations. This would enhance the legitimacy of the regulatory mechanisms and may provide a way of countering the disconnection between ‘transplanted institutions’ and local economic actors, while providing legitimacy to the formal institutions.

4.2 Tax policies and administration reform

Inappropriate taxation systems have been found to encourage informality. Micro and small enterprises (MSEs), medium and large firms alike fail to comply with the tax system if it is too complex, expensive, opaque, or perceived to be unfair. In many cases, MSEs are simply not aware of their tax obligations or are fearful of the tax system.

The requirement to register with the tax authority and submit regular tax reports and payments is often considered a major barrier to firm formalization. Emerging market and developing economies (EMDE)’s with above-median rates of informality had tax regulations that took the average firm an additional 33 hours to comply with compared to EMDE’s with below-median rates informality (Ohnsorge and Yu, 2021). The aim of tax reform is to make tax administration more transparent and
efficient, which includes broadening the range of the tax system to include firms that were previously excluded or exempt. The *IFC Jobs Study* argues that ‘a streamlined tax system can increase the number of firms in the formal economy, facilitate investment, widen the tax base, and rationalise a company’s tax compliance cost’ (IFC 2013; 47). Inefficient tax administration, such as those with multiple taxes, cumbersome procedures, and high compliance costs, impose significant constraints on businesses, particularly SMEs. Likewise, the tax inspections that formal firms receive may add transaction costs and increase operating uncertainty, leading some firms to avoid both fiscal as well as legal formality.

In their review of the evidence, White and Fortune (2015) find that reforms that streamline and improve tax administration have been successful in making more firms likely to register for tax as a result of the reform effort. In Vietnam, Boly (2015) found that firms that switch from informal to formal pay less tax and have a lower probability to do so, compared to non-switching formal firms. He suggests that, as an implication, governments should adjust their tax collection provisions downward if using incumbent formal firms as the reference group. While in Brazil, Fajnzylber and Montes-Rojas (2011) found that reducing the tax burden on small, eligible firms by about eight per cent led to more firms registering for tax—also see Box 2 which describes a case of a simplified tax status that can be used to reduce compliance costs. Similarly, improving the ease of paying taxes is associated with declines in informal output, however the effects may take several years to be realized. Ohnsorge and Yu (2021) find that for every one point increase in the ease of paying taxes, the informal output was reduced by 0.1 percentage of GDP and was statistically significant.

**Box 2: Case Study: Simples National in Brazil**

Simples National or *Simples Nacional*, provides a mono-tax and simplified procedures for own-account workers and MSEs for business registration, taxation, social security, financial inclusion and government procurement. It includes, amongst other elements, a special statute called Individual Micro Entrepreneur, or *Micro-Emprendedor Individual*, which is a simplified tax and social security regime for own-account workers with up to one employee that meet eligibility criteria with respect to sectoral activities and turnover threshold.

By mid-2018, 6.9 million persons were registered under the Individual Micro Entrepreneur regime and 4.8 million MSEs were registered under the mono-tax regime. The entities registered under the mono-tax regime employed 10.6 million employees (in late 2017), representing a quarter (i.e., 26.7 per cent) of the total formal employees in Brazil.

The mono-tax scheme has effectively reduced the total amount of taxes to be paid by the registered entrepreneurs and facilitated access to social security. Despite this, tax evasion remains high—about 46 per cent of all Individual Micro Entrepreneurs were in arrears in 2018. Other challenges relate to the sustainability of the regime (which is linked to the expansion of eligibility criteria, low level of contributions and high subsidies), along with illicit registrations, including by workers in disguised employment relations.

SOURCE: ILO (2019a)
4.3 Improvement of labour laws and administration systems

The issues associated with labour law, regulation and administration are often considered an obstacle for formalization, including the formalization of informal workers. Indeed, even when firms are registered and licenced, they may employ staff in an ‘informal’ manner (i.e., employing unregistered workers).\textsuperscript{19} Moreover, in some countries, MSEs may be excluded from the provisions of the labour law simply because of their size. Thus, by this measure, such firms are formal (i.e., compliant), even if their owners and workers are not fully covered by the provision of national labour laws. Thus, this topic concerns informal and legally formal firms.

Reforms to the labour law include minimum wage and employment protection legislation.\textsuperscript{20} Chen (2007) argues that labour market deregulation is associated with the rise of informal employment and creates a situation in which workers are caught between two contradictory trends: rapid ‘flexibilisation’ of the employment relationship, making it easy for employers to contract and expand their workforce as needed, and slow liberalisation of labour mobility, making it difficult for labour to move easily and quickly to new opportunities.

Reforms in this field tend to promote the ‘re-regulation’ (rather than ‘deregulation’) of labour markets to protect informal workers from the economic risks and uncertainty associated with these trends. The challenge is to find the balance between increasing the level of protection for formal workers, while encouraging informal firms to adopt more formal employment practices and gradually transition to the formal economy. Hampwaye and Jeppesen (2014) studied the effect of state-business relations in Zambia and found that the issues which affected the majority of food processing firms in the country were related to the labour laws, in particular the minimum wage regulation of 2012.\textsuperscript{21}

Xu (2011) claims that firm-level studies of labour regulations in developing countries suggest that labour flexibility facilitates faster factor adjustments, and a more efficient distribution in firm sizes. Evidence from China shows that labour flexibility improves firm performance (e.g., sales growth, investment rate and employment growth). Besley and Burgess (2004) examined the relationship between regulation and development in India and found that, so-called, ‘pro-worker’ labour reforms tended to reduce investment flows and did not translate to better employment outcomes for workers.

The ILC (2015, para 18) recommends that states ‘progressively extend’ social security provisions, maternity protection, decent working conditions, and a minimum wage to the informal economy, in ‘law and practice’. These may protect worker’ health as well as provide minimum income levels, particularly during times of illness, injury, old age, etc. (ILO, 2021c). The DCED (2011) Annex says the ‘challenge of balancing enterprise growth and workers’ protection calls for an active role of the state,

\textsuperscript{19} See Fudge (2020).
\textsuperscript{21} In particular the minimum wage regulation of 2012 (Hampwaye and Jeppesen, 2014).
particularly in implementing a legal framework for the labour market, basic social protection (e.g., health and safety, minimum income), and skills development.’

Writing on South Asia, White (2014) suggests that labour and business laws and regulations should provide easy entry points for compliance and formalization, including the concept of a sliding scale of compliance requirements as firms grow. Thus, as the informal firm formalizes, such as through firm, tax or worker registration, its compliance obligations increase over time, rather than with an immediate barrage of reporting, inspection and payment obligations. Vargas (2020) studied labour law provisions in 16 developing countries and found a general trend towards the extension of equal protection to all workers regardless of the enterprise size, including those in the informal economy and in self-employment. To achieve this, governments reformed labour laws and applied other frameworks and policies. Chief among these was the use of ‘social control’ in which state and non-state actors encourage actors to comply. While the state is the main actor in an enforcement model, the social control model described by Vargas (2020) involves a range of other actors, such as managers, unions, individuals, and social groups. The advantage of this model ‘is that it enables policymakers to identify a variety of actors and normative systems beyond the realm of the state that are involved in daily efforts to achieve compliance with labour law’ (p. 40).

Developing policy that provides access to support for workers while aligning with the status with the firm (i.e., number of employees, revenues, etc.) can protect informal workers, helping to bring them into increasingly formal employment, and through a stakeholder-centric policy development process, increase employer compliance that leads to increased firm formality.

4.4 Financial sector reform

Reforming the legal and regulatory framework of the financial sector can lead to better outcomes for informal firms while also supporting the transition towards formalization. Bose, et al. (2012) found that among 137 economies from 1995-2007, greater efficiency and depth of the banking sector were associated with reduced rates of informality. For example, ten more bank branches per 10,000 adults is associated with a 0.1-0.3 percentage point decline in the share of informal output in the following one to five years after the increase of bank branches (Ohnsorge and Yu, 2021). Similarly, firms that report financing as a major obstacle were more likely to hide a portion of their sales (Dabla-Norris, et al., 2008).

The introduction of new or innovative financial services and products is discussed in the following chapter under the topic of initiatives that complement BER to promote firm formalization (see Section 0).

Financial sector reforms that are oriented towards the informal economy often overlap with broader approaches to financial inclusion. Several notable approaches have arisen in this regard, such as the creation of credit bureaus and registers for movable assets and alternative means of assessing
creditworthiness for those without a credit history. Increasingly, attention is being given to reforms that enable online banking and cashless, digital payment systems.²²

Farazi (2014) finds that the use of loans and bank accounts for business by informal firms is exceptionally low. A vast majority of firms finance their day-to-day operations and investments through sources other than financial institutions (i.e., internal funds, moneylenders, family, and friends). Firm size, the level of education of the owner and whether the owner has a job in the formal sector are significantly associated with financial inclusion of informal firms. Tiendrebeogo (2020) finds that the quality of institutions positively influences financial development and the size of the informal sector.

Kanji (2015) recommends that policy incentives be introduced to encourage financial institutions to develop profitable initiatives that promote the formalization of their informal clients. This includes the use of formal bank accounts to ensure informal enterprises gradually transition to more formal status, and in doing so, bring their workers into an increasingly formal status. In Chile, BancoEstado Microempresas serves informal firms but only provides access to a second loan, an increase in the loan and/or the provision of other financial products if the firm is making progress towards formalization and registers their business (ILO, 2021d). To support movement towards formalization the bank provides a series of trainings and created a unique entrepreneur account for those firms that started informal and eventually registered their business. Within two months of creating this pathway, over 700 micro and small enterprises had registered.

### 4.5 Other less effective reform areas

There are several other reform areas that are typically a focus for BER oriented towards firm formalization. However, the results of these efforts have less evidence leading to unclear reform implications.

#### 4.5.1 Land titles, registers and administration reform

Access to land is often raised as an obstacle to formalization and enterprise growth. This is typically framed in relation to the ability of an informal firm, or in many cases, informal and smallholder farmers, to use land titles as collateral against a commercial loan.²³ However, land administration reform is a difficult and costly field of reform (e.g., cost of surveying land) and its impact on informal farmers and enterprises is unclear (White and Alyward, 2016).

Comparing land-tenure security enhancing reforms in Ethiopia, Vietnam and Uganda where informality survives in the land market, Smith, et al. (2007) found examples of the detrimental effects of informal land-tenure systems, particularly on poor households: ownership disputes, reduced land

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²² For example, see Financial Sector Deepening Kenya (2016).

²³ For example, the United States Agency for International Development (USAID 2013) argues that property rights increase the likelihood of farmers making longer term investments in their land, increase access to credit so landholders can more easily finance on-farm investments, enable land transfers through more dynamic land markets, and make it more likely to attract the further investment necessary for broad-based economic growth.
values and difficulties in mortgaging informally held land. This research suggests that poor people may benefit more from efficient, inclusive and low-cost formal land administration systems than from attempts to protect them from market forces. In particular, a number of female-headed households seem to have benefitted in Ethiopia\textsuperscript{24}. Minot and Goletti (2000) analysed the effects of the liberalisation on the production and marketing of rice in Vietnam and found that poorer households benefitted from liberalisation and argued that the relatively equal distribution of land was an essential prerequisite if market reform was to translate into growth as was the earlier development of infrastructure. However, not all agree that formalization is the solution. Bromley (2009) provides a secondary analysis of the literature and concludes that poor people are poor because of a broader set of ‘flawed economic policies.’ He argues there is little empirical evidence linking the formalization of land titles to poverty reduction, and that land tenure reform should not be elevated above other policy reform priorities. Payne et al (2009) and Cousins et al (2005) support this view. Stein et al (2016) find little evidence to support the view, taken by a ‘multiplicity of actors at great expense to donors, individuals and the government of Tanzania’, that farmers can use land reform to access the formal banking sector. Zinnes (2009) agrees with this position, arguing that farmers would not risk their single most important asset by using it as collateral.

4.5.2 Judicial reform

Many courts in developing economies are plagued by a demand for services that far outstrip their capacity to deliver in a swift and cost-efficient manner. For informal firms, this problem is exacerbated by the lack of a legal status. Because informal firms do not typically have access to the formal commercial court system, they are often required to ‘restrict their transactions to the immediate locale and to be with those parties with whom they have personal or social ties’ (Zinnes, 2009).\textsuperscript{25} In some cases, judicial reforms relevant to informal firms include the introduction of alternative dispute resolution (ADR). This refers to any process that resolves a conflict or dispute using processes other than litigation. The forms that ADR takes include arbitration, mediation and conciliation.\textsuperscript{26} Against this is an increasing emphasis on supporting informal justice systems (see United Nations 2013). Moreover, the Commission on Legal Empowerment of the Poor (2008) recommends the improvement to identify registration systems, without user fees, and the strengthening of legal aid systems with expanded legal service specialists.

\textsuperscript{24} The subject of land titles and ownership intersects with the gender dimension previously described. Women are less likely to have land titles and have less control over land (Salcedo-La Viña, 2020). United Nations’ Sustainable Development Goals note this as a subject to be addressed and is noted in SDG Nos. 1, 2, and 5.

\textsuperscript{25} The DCED (2011) Annex describes how policy reforms in this field typically focus on improving access to formal dispute resolution channels, strengthening and improving the quality of customary and traditional governance methods, improving linkages between (and greater awareness of) formal and informal systems of justice, and improving access to justice in bureaucratic administration.

\textsuperscript{26} Commercial dispute resolution, whether through conventional routes such as the formal justice system or through ADR is essential to a thriving and vibrant business environment. This is true at a national level as well as at regional and international levels. With rapid globalization, differences in interpretation of contracts and other legal agreements tend to multiply, and disputes will inevitably arise owing to misunderstandings based on differences in culture, language and local norms.
Overall, little attention appears to have been given to the influence judicial reform has on formalization. While more research on this may be justified, it appears to be an issue that is more oriented towards addressing the concerns of informal firms and workers, rather than supporting a transition towards firm formalization. However, as workers and firms perceive greater opportunity to exercise their rights due to a better functioning judicial system, there may be greater incentive to formalize.

4.5.3 Intellectual property rights

The World Intellectual Property Organization (2005) highlights the importance of intellectual property rights as well as ‘traditional knowledge’ for indigenous people. Improved rights can ensure this knowledge and genetic resources are not misappropriated or misused. On a broader scale, poor intellectual property policy can lead to informal provision of substandard products. While these initiatives aim to provide economic opportunities for operators based on consumer benefits and protection under legal operation, they appear to be a lower order priority when focusing on firm formalization.

4.6 Overall impact of reforms on formalization

Multiple analyses have been conducted to comprehensively understand the impact of reforms on formalization. In a unique meta-analysis of studies conducted on the impact of formalization interventions, Floridi et al. (2019) find that interventions had a small, positive, statistically significant result. In an updated review, Floridi et al. (2021) find small benefits to the firms themselves because of formalization in terms of their performance over time, largely through increased revenues. And when comparing the benefits of a policy-induced formalization to a self-induced formalization, policy induced formalization was found to be more effective, suggesting there continues to be opportunity for government and donor reform efforts. A recent study from Jessen and Kluve (2021) evaluate 32 academic studies that evaluate empirically one or more formalization interventions. They find the reform or intervention type is not a strong determinant of the effectiveness of the intervention, however tax incentives and inspections were likely to have positive effects. Worker registration interventions were often the most effective. And when considering the scale of the intervention – policies as opposed to singular programs (such as a small experiment) were more effective (Jessen and Kluve, 2021).

Klapper and Love (2010), note the importance of the scale of the reform and the number of reforms conducted simultaneously. Specifically, they find that small reforms (i.e., less than a 40 per cent reduction in procedures or 60 per cent reduction in costs) do not have a significant effect on new registrations, and that there are important synergies in multiple reforms of two or more business

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27 Interventions included various combinations of: access to information, education (banking, registration, etc.), financial incentives to register, reduced registration costs and time required, reduced tax burden, less burdensome legal and tax statuses, enforcement reforms, access to finance.

28 Time periods varied by the duration of follow-up within the underlying study used in the meta-analysis.
environment indicators. Ohnsorge and Yu (2021) continue this finding, noting that a comprehensive policy package tailored to country circumstances offers the greatest chance of success in reducing informality. These can include streamlining regulations, ensuring effective enforcement, increasing labour market flexibility, improving public service delivery, expanding access to finance, and improving governance among other policy measures that directly or indirectly can support declines in informality. These must also consider unintended consequences.

Part of the discussion around supporting formalization must also consider the distinction between transitioning to formalization vs. starting formal. Studies have noted this to be an important factor. Safavian et al., (2016), note that there may be little crossover in terms of the number of formal firms that began in the informal economy. They go on to note that La Porta and Schleifer found only 21 per cent of micro formal firms, 11 per cent of small formal firms, five per cent of medium formal firms and two per cent of large formal firms were not registered at start-up. As a result, supporting formalization in most cases means, supporting formalization in the first year or two of the firm’s operations. This aligns with the recognition that businesses with the intention to grow often start with that intention and having this intention means there is increased likelihood of recognizing the need to operate formally.
5. Measures that complement business environment reforms

The limitations of BER in promoting firm formalization and the corresponding benefits of having achieved formalization have been well established, as has the need for complementary approaches that can be used alongside reform programmes. The challenge in this field and the emerging new evidence concerns the purpose and scope of these complementary approaches.

There are two important and related themes to this.

The first theme deals with the instruments that can be used to complement BER to enhance the formalization of informal firms. This also encompasses a need to better understand what kinds of BER interventions work best. The objective here is to use BER and any complementary activities to shift informal firms towards formalization.

The second theme deals with the use of BER and other instruments to address the immediate needs of informal enterprises and their workers. The objective here is not necessarily push informal firms towards formalization, but to help address the immediate needs of informal enterprises and their workers.

Neither of the above themes should be considered mutually exclusive. It is entirely possible to encourage the transition of informal firms towards formalization, while at the same time, supporting the introduction of reforms that address the immediate needs of informal enterprises and their workers. However, it is not necessary for all reforms or their complementary initiatives to attempt to meet these dual ambitions. The decision of governments, business representatives, workers’ representatives, civil society, and development partners, will be based on their diagnosis of the causes and characteristics of informality and the capacity of a reform or support programme to address these. Finally, while reforms and programmes may be termed ‘complementary’ in this discussion, these reforms often have broad implications in their own right and could impact rates of formalization on their own.

5.1 Complementing reforms to enhance firm formalization

As described above, there is broad agreement that supporting the formalization of informal economy and the transition of informal firms towards formalization requires more than a simply making the legal and regulatory framework cheaper and easier to comply with. There are several factors beyond the immediate cost of registering and licensing that influence a business owners’ decision to formalize. These include, but are not necessarily limited to, the perceived benefits of formalization.

29 The ILC (2014; 36) highlights the economic contribution of the informal economy and recommends this should be recognised in national policy, ‘restricting and regulating it when necessary, but mostly seeking to increase the productivity and improve the working conditions of those who work in it so as to facilitate transitions to formality.’
(e.g., access to government services, access to new markets, access to social security for the self-employed), the application of carrots and stick (i.e., incentives to register and greater enforcement) and the desire of business owners to grow their business, either in terms of increased sales, profits or workers.

5.1.1 Using behavioural insights to inform reform design and delivery

Development policy typically targets financial resources, laws or incentives. These are the conventional tools used by policymakers to support formalization. However, the rise of behavioural science has led to new insights that can help in understanding informal firms’ and workers’ decision-making.

The OECD (2015) suggests that formalization strategies hinge on three policy pillars: deterrence, incentives and persuasion. While the first two approaches try to alter the cost-benefit ratio for entrepreneurs to stay in the informal sector, the third seeks to win their ‘hearts and minds’ by fostering a culture of compliance. Persuasion can apply both a generic and specific approach. Generic approaches include awareness-raising and tax education campaigns that address the wider society. This typically informs the population about the risks of working in or buying from the informal sector. Tax education campaigns, on the other hand, inform citizens of what the tax system requires of them and what happens to their taxes. Indeed, a significant part of tax evasion is unintentional, resulting from lack of knowledge or misunderstanding of the law (Williams and Nadin, 2014).

The use of behavioural science recognizes ‘rules of thumb entrepreneurs’, status-quo biases that limit the perceived set of opportunities and instances of high stress that reduce decision-making ability (see Alm and Torgler, 2012; Mahmud, et al., 2017; Shapiro, 2015). Use of behavioural insights to address these biases involve recognizing the mental models of business owners and managers. This refers to the beliefs, concepts and ideas informal business owners, managers and workers use to understand the world around them. The use of mental models helps to address their perceptions and value what needs to be addressed within them. Behaviourally informed policy can identify typically overlooked aspects of policies and recognize potential misalignment between policy objectives and informal firm decision-making. This can lead to increased effectiveness of reforms and interventions.

For example, Mendoza and Wielhouwer (2015) report that ‘trust-based regulation’—where compliance is rewarded with the lower chance of an audit—is feasible when the businessowner sufficiently values the future. That is, when the ‘carrot’ of compliance over the longer term is recognised, then there is less need for the ‘stick’ of penalties. Thus, while policy recommendations often point toward increasing deterrence, their research shows that the opposite can be optimal for the businessowner and the regulator.

Recognizing opportunity for improvements in BER design and delivery requires the use of a series of tools to run a diagnostic of issues at hand.30 These tools help to identify behavioural obstacles,

30 Tools include: journey mapping (i.e., a step-by-step representation of a user’s interaction with a service), mystery shopping (i.e., anonymous individuals take part in a shopping or service experience, without the business or government knowing, and provide feedback on the experience), gamification (i.e., the use of game-design elements in non-game settings to increase user engagement), and observations.
particularly those that are outside ‘rational’ economic decision-making. Such obstacles can be addressed through behavioural interventions, sometime known as ‘nudges’, built into the BER that support increased compliance. Behavioural interventions may address individual-level behaviours, such as present bias, which would benefit both firms and workers who face decisions around the investment of capital and time and a clearer picture of how returns may vary. Similarly, interventions could be designed to boost the effectiveness of existing reforms. Examples include improved communication of reforms, key messaging to promote the desirability of registration, and the simplification of language to avoid excluding those unfamiliar with government processes.

Interventions can take on both economic and behavioural design components. Economic interventions include tax incentives, reduced registration costs, etc. When applied with a behavioural perspective, these initiatives can nudge individuals to take the step towards formalization by registering, paying tax, etc. (Loewenstein and Chater, 2017).

The evidence with regard to behavioural science and firm formalization is still in the early stages of development and would benefit from further research.

Box 3: Case Study: Bulgaria’s Campaign - Come into the Light

In 2007, Bulgaria launched a national campaign called ‘Come into the light’ where employer associations, unions and media outlets, with the support of the government, came together to design initiatives that would raise awareness about the negative consequences of the informal economy.

Led by the Bulgarian Industrial Association (BIA) and the Bulgarian Industrial Capital Association (BICA), the initiative sought to unite all organisations and institutions in Bulgaria to combat the ‘grey economy’ and undeclared work. This involved raising public awareness concerning the negative effect of informality; publishing the activities and experiences of companies and organisations that work in the formal economy as examples of good practice; spreading international best practices; and offering practical mechanisms to combat the grey economy. The programme also gave web users the opportunity to suggest ideas to deal with the informal economy and to complain about common labour law violations in the country via the project website.

SOURCE: Eurofound (2009)

5.1.2 Building trust and public private dialogue

Some informal firms may be informal due to limited trust in the public sector. Should a cost perceived on the part of the informal entrepreneur be the lack of trustworthiness in the government, stricter enforcement of formal procedures to register and file taxes may do little to foster increased rates of formalization as the root of the problem is not being addressed – the root problem being potentially many of the subjects previously discussed such as high perceived corruption, lack of perception of

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31 Present bias is the tendency to over-value benefits in the near-term compared to potential longer-term benefits.
government considering one’s needs, perceived unfair regulation, weak institutions, etc. This is not to say however that some element of enforcement is not needed – it is a balance.

Trust has a positive and statistically significant correlation with the probability of becoming an entrepreneur while controlling for education, age, and income. And multiple studies have found that trust leads to entrepreneurship rather than entrepreneurship leading to higher levels of trust (Ortiz-Ospina and Roser, 2019; Guiso, 2006).

A part of building trust in the government is inclusion and addressing barriers to be able to understand the government’s work and build trust in them. Efforts to support inclusion that help build social and institutional trust include improved access to finance and banking for individuals and business, education and skill training, health care options, improved access to transportation and communication, access to fair court processes, improved ‘cultural competency’ and use of multiple languages, strengthen the capacities of governments to deliver on their mandates, among many other potential avenues (Lord, 2019; Zak, 2006).

In the fiscal dimension of informality, private sector firms’ tax compliance is a function of their perceived level of service provided by the government and the fairness of their tax burden (Lee et al., 2019). The perceived fairness may be influenced by the extent other businesses comply with taxes, the potential variation in tax rates that may benefit different sizes of businesses, and/or the belief that a certain tax should exist in the first place. Tax compliance has thus been found to be influenced by people’s trust in the government. Studies by Kirchler, et al. (2008 and 2010) have shown that high trust in a tax authority increases tax compliance.

A tool for facilitating this trust and addressing the issues that may be most prominent for informal businesses and workers is the use of public-private dialogues and private sector consultations. These tools consist of feedback loops, as firms sharing experiences and policy effects with government, who respond accordingly to reform policy as needed. For example, these can support trust building by increasing transparency of policy making, encourage broader ownership of the policy’s development, give a voice to stakeholders impacted by a policy, as well as increase awareness of the existing policy limitations (Rosen 2017; Herzberg and Sisombat 2016). Allowing for citizen participation in their own governance has been shown to support feelings of trust in the government as well through increased transparency, feedback/engagement, and accountability. Existing evidence suggests a causal relationship between participation and levels of tax compliance, as citizens and businesses are more willing to pay taxes if they feel their preferences are being heard and acted upon (Howard, 2012; Estefan and Weber, 2012). For example, Cabannes (2004) conducted a comparative study of 25 municipalities around Latin America and Europe and found a significant reduction in levels of tax delinquency after the municipality adopted participatory budgeting. In Porto Alegre, property taxes grew from six to 12 per cent of the municipality’s revenues over the 10 years following participatory budgeting. Further, visibility of the work and services done as a result of the participatory budgeting process also supports the public’s willingness to pay (Cabannes 2004).

These however must consider who is being communicated with. Access to the communication tools can create a selection process that limits who participates and the type of feedback that can be collected. This risk becomes quickly apparent for informal firms and workers who tend to have less
access to governments, particularly women, minority and previously disenfranchised groups (Bettcher, et al., 2015).

Important to this process is the closing of the feedback loop whereby results of communications are shared back with the informal firms and workers so that they see what steps were taken to address their thoughts (Wille and Roberts, 2015). This shows government responsiveness and accountability and also makes businesses more likely to continue to use the feedback mechanisms again if they feel the data was managed fairly and their voice was heard.

**Box 4: Case Study: Business registration and trust in Serbia**

A World Bank working paper examines the effects of transferring business registration from regional courts to a centralized agency in Serbia, thereby transforming registration from a highly adjudicative practice to a simpler administrative process. The authors found that going from the region with the lowest level of distrust to the region with the highest level, the reform increased the number of new firms by up to 34 per cent. Thus, the effect of the reform is larger in regions with high distrust in courts. This effect is also larger compared to those of other types of registration reforms, suggesting that courts and/or low trust can pose significant barriers to new firm creation. This signals to future policymakers the importance of considering trust as a variable in the design of reforms and the potential impact it may have on the results achieved.

**SOURCE:** Bruhn et al. (2018)

Part of the obstacle of trust-building is that in many countries, corruption is commonplace. Corruption is a component of society that tends to work in inverse of trust levels. Williams and Shahid (2016) find that in Pakistan higher perceived levels of public sector corruption increase the likelihood that a business will operate informally. As a result, many of the initiatives that can be taken to reduce corruption, also correspondingly increase trust levels and lead to desired outcomes of increased compliance and reduced informality. The approach to building trust can involve not only the informal firms but also the government officials as well. For example, educating government officials about the role of the informal sector, the jobs it supports, may help alter their perception of informal activity and reduce harassment and corruption. Future studies may build an understanding of how interventions such as the example described can be used to complement BER reforms.

**5.1.3 Digital solutions reduce vulnerabilities and support transition to formality**

The emergence of digital technology in developed and developing economies around the world is changing the way business is done. This offers new opportunities for reformers, policymakers and informal business owners, managers and workers.

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32 In comparison, previous studies have estimated about a five per cent increase in new firms due to the introduction of one-stop shops in Colombia (Galiani et al., 2015) and Mexico (Bruhn, 2013) and a 17 per cent increase in Portugal (Branstetter et al. 2013).
In recent years, digital technologies have been used as a central theme in the improvement of business environments. However, the direct impact of digital reforms on firm formalization appears unclear and under-research. What is clearer, is the opportunities digital technologies offer for engaging the informal economy. As the proliferation of mobile phones and increasingly smart phones occurs, this serves to create multiple potential channels for communication, generation of policy feedback, understanding key obstacles to formalization, among other objectives. Digital tools can also serve to support reforms, providing step by step guidance to firms and workers on how to take advantage of new policies.

Policymakers have recently identified the digitalisation of micro, small and medium-sized enterprises (MSMEs) as a key priority area and highlight the potential of digitalisation for MSME growth and poverty alleviation. The United Nations Conference on Trade and Development (UNCTAD 2019) *Digital Economy Report 2019, Value Creation and Capture: Implications for Developing Countries*, calls on governments to consider collaborating with the private sector to provide more training to MSMEs on how to leverage digital platforms. The USAID (2020) *Digital Strategy 2020–2024* highlights the contribution digital ecosystems have to equipping MSMEs, such as informal merchants, women entrepreneurs and smallholder farmers, with access to markets, information, and finance. The International Organization of Employers note that these digital tools can support simple digital business registrations as well as provide another channel with which to extend social protections to informal workers (IOE, 2021).

Similarly, Cariolle and Carroll (2020) suggest that digital technologies may also be instrumental to firm performance and job creation by improving the business environment. While USAID (2020; 27) recommend that donors help ‘foster robust digital ecosystems by strengthening local capacity, promoting policy reform, catalysing the market, investing in digital global goods, and mitigating risks that hinder sustainable investment.’ For example, in 2009, Costa Rica reduced the time required to register a business by digitizing tax registration records and company books (World Bank, 2009). Following this, from 2009 to 2016 informal employment dropped by four percentage points, and informal output dropped by about two percentage points of official GDP (World Bank 2019b).

And in the time of COVID-19 the digital tools can create opportunities for providing cash transfers or connecting the informal worker to other resources they may need such as connection to food assistance and connection to job opportunities. For example, use of mobile money accounts have been increasingly widespread and serve both to support financial inclusion but also act as a means for distributing stimulus money, paying taxes, or distributing tax credits. In addition, digital payments during COVID-19 were used to facilitate access to funds for operators in the informal economy. The digitalizing of financial records can have longer term effects by building a track record for business operations and supporting access to financial services and wages, as well as a transition to formality for workers and enterprises.

The Global Partnership for Financial Inclusion (2018) describes how digitisation offers an unprecedented opportunity to address eligibility and affordability barriers to formal financial

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inclusion faced by informal individuals and firms. In particular, digitisation can (i) facilitate identity verification, (ii) promote digital payments and (iii) improve the information environment. However, to fulfil its potential digitisation also requires attention to (iv) financial consumer protection and financial literacy. Schulz (2021) suggests that digitalisation can offer a path towards formality and financial inclusion for businesses operating in the informal economy.

5.2 Complementing BER to address the immediate needs of informal enterprises and their workers

This section considers the range of areas in which BER can be used to address the immediate challenges facing informal firms and their workers such as reducing vulnerabilities and supporting increased productivity. This does not suggest that these reforms compete with or otherwise distract from a firm formalization agenda. Instead, the reforms described below focus on current challenges and opportunities and may or may not contribute to a broader formalization agenda. There are many ways the informal sector can be targeted and supported through means that complement BER such as financing (Degryse, et al., 2013), extending social protections (Da Costa et al., 2011), managerial training (La Porta and Schleifer 2014), or improved public service delivery (Ghani and Kanbur 2015). Interventions conducted, however, note the often-heterogeneous effects that result.

5.2.1 Boosting innovation in the informal economy

There are many proponents for the promotion of innovation in the informal economy. While this appears to be an under-studied field, observers highlight the importance of this approach, as innovation may support productivity. For example, Neuwirth (2011) describes ‘the global rise of the informal economy’—what he calls, ‘System D’— highly integrated supply chains that stretch from back streets in China to umbrella-stand merchants half a world away. Similarly, Daniels (2010), in his book, Making Do: Innovation in Kenya’s Informal Economy, describes the vibrancy of the informal economy, when compared to the ‘sluggish’ growth of Kenya’s formal sector growth. He considers the informal sector to be a sign of an emerging ‘new industrialisation’. While Clay and Phillips (2016) in The Misfit Economy, present ‘lessons in creativity from pirates, hackers, gangsters and other informal entrepreneurs.’

As indicated above, the DCED (2011) Annex recognised the significant role of informal economic activity in promoting innovation and acting as a buffer to economic shocks. Because of this, it was recognised that BER can help improve the conditions in which informal actors operate. De Beer et al. (2016) examine the role of innovation in the informal economy and the flow of knowledge and technology via simple exchanges of ideas. Depending on the sector, they find that informal entrepreneurs imitate and copy products from each other, from local formal and informal industries and from imported products. Indeed, large amounts of ‘constraint-based innovations’ take place under conditions of survival, scarcity and constraints to address mostly the needs of less-affluent customers. Moreover, innovations are rarely driven by R&D. Most often, innovation is driven by knowledge gained through adopting, adapting and improving available good ideas, best practices and technologies in novel and economic ways to solve customer problems.
Informal sector innovation is more likely to be incremental, rather than radical. While innovations in the informal economy have various connections with the formal sector, sophisticated technologies and machinery are rarely used. Knowledge, skill, capital, people, and other types of resources can sometimes flow both ways. However, innovations are often geographically concentrated based on collaboration and information sharing (De Beer et al., 2016).

Informality however can restrict innovation as well. Floridi et al. (2021) find that informally created firms suffer from informality costs that reduce their incentives and ability to contract with internal and external contractual parties and end up hampering the innovativeness of their new products, leading them toward imitation. These informality costs not only affect informal firms while they are informal, but also are ‘imprinted and persist even after the informally created new ventures have become formal ventures’.

Daniels (2011) suggests the main barrier to innovation and growth for entrepreneurs is risk. This is supported by the OECD and ILO (2019) finding that the lack of access to social protection and appropriate risk management instruments ‘pushes many informal economy workers into income insecurity or vulnerability to income poverty.’ Moreover, these risks and vulnerabilities are higher for women in the informal economy. Daniels (2011) argues that risk can be reduced by improving access to resources like credit, tools and skills. It is also important to promote a ‘culture of innovation by using market intelligence, working with customers to co-create products and improving the design process’. He presents Maker Faire Africa, a festival for craftspeople, as an example of this. Maker Faire Africa has sparked a social movement around informal innovation by rewarding those who demonstrate inventiveness and risk-taking.

### 5.2.2 Extending social protection to actors in the informal economy

As with labour law and administration, the extension of social protection to the business owners of informal firms and their workers is a critical challenge. This challenge encompasses the formal MSEs that are excluded because they fall below the enterprise size threshold for national social protection schemes (e.g., firms with less than 20 workers) as well as informal firms that are, by definition, unregistered. The lack of social protection is a major contributor to the vulnerability of informal firms and their workers. Thus, there are two broad and often interconnected challenges here. The first is for governments to extend access to social protection benefits in order to reach workers in MSEs, whether formal or informal. The second is to help informal enterprise owners and workers to see the value in contributing to social protection schemes. The ILC (2015, para 25f) recommends the introduction of progressive social security contributions, subsidies for social security contributions on low-income wages, the existence of a solidarity pillar, and the reduction of the administration costs of social security schemes. Good, inclusive schemes are those with simple, affordable contribution rates that are integrated into one single payment or with a payment schedule that can be adapted.

Considering the issue of social protection in rural populations, the ILO and FAO (2021) suggest it is important to develop the economic case for the expansion of social protection coverage. This would promote the investment value of social protection for ‘human capital development, economic inclusion, inclusive rural transformation processes and ultimately rural development’. Researching formal firms in Indonesia, Torm (2020) found that increased social security spending of ten per cent...
is associated with a per-worker revenue gain of up to two per cent. Moreover, profits did not decrease due to the increased social protection coverage, suggesting that increasing worker benefits may be a worthwhile business investment. While in Vietnam, Lee and Torm (2017) found that firms that increased their social security coverage by ten per cent experienced a revenue gain of 1.4–2.0 per cent per worker and a profit gain of up to 1.8 per cent. Thus, not only do workers but also firms stand to gain from increased provision of social protection.

Lee and Torm (2017) and Torm (2020) make useful recommendations on extending social protection to MSE and their workers and using this to encourage firm formalization. While MSEs often operate with a short-term perspective, they can be encouraged to consider the long-term benefits of social protection through the introduction of subsidized initial contributions. A more progressive system employing tax breaks and other financial incentives could serve to encourage informal firms to become formally registered. ILO (2021b) also described how promoting greater access to social security benefits and using these benefits can be used as an incentive for formalization.

Winkler et al. (2017) note the importance of non-contributory social insurance programmes for informal workers, but also find their use must be carefully planned or risk not being financially sustainable and may lead to further market segmentation and disparities. In some cases a robust non-contributory social insurance programme may disincentivize the formalization of employees, particularly if the protection scheme accessed as a formal employee is less comprehensive than that accessible while informal.

5.2.3 Developing human capital in the informal economy

While the causality of relationship between human capital and workers in the informal economy is unclear, there is evidence that many people working in the informal economy are poorly educated. For example, La Porta and Schleifer (2008) note that, based on World Bank enterprise surveys, only seven per cent of managers of informal firms have a college degree, while among formal firms, 76 per cent of managers have a college degree. Human capital is also a statistically significant determinant of productivity. Gennaioli, et al. (2013) estimate nearly 30 per cent returns per extra year of education of managers. This suggests that much of the reason informal firms are unproductive is the low level of human capital in the people who run them. Similarly, de Mel et al. (2012) find that about 70 per cent of informal self-employed entrepreneurs in Sri Lanka have characteristics more like wage workers than those of owners of firms.

Adams et al. (2013) find that to improve productivity and incomes in small businesses and household enterprises of the informal sector it is necessary to consider factors behind the sector’s shortfall in skills. This includes: the low education of people in the sector, the unequal access to training experienced by some groups, the presence of inefficient markets encouraging skills development, the lack of interest in the needs of the informal sector shown by public training providers, and the existence of other market constraints to training for informal sector enterprises.

The ILO has developed resources to support vocational and technical skills development in the informal economy. Noting that ‘informal apprenticeship systems are the most important training system in many informal economies’, the ILO has described how small industry and community organizations can bring master crafts-persons, apprentices, customers and the market together to
support skills development (Lange and Baier-D’Orazio 2015). Palmer (2020) describes how lifelong learning strategies and investments in skills for informal economy workers is necessary for real progress to be made towards transitions to formality. This requires a whole-of-government approach with skills policies that are horizontally and vertically aligned. The early development of foundation and core work skills can lead to a virtuous cycle of skills formation, and lay the groundwork for advancing foundation, core work skills, as well as the acquisition of technical and vocational skills.

5.2.4 Promoting enterprise development in the informal economy

The DCED (2011) Annex suggests that donor and development agencies should ‘complement business environment reform with supply-side responses.’ As discussed in Section 0, economic growth creates a greater demand for formal employment which is a powerful force that pulls informal businesspeople and workers into the formal economy and into more productive and decent employment. However, complementary approaches are often needed to help informal firms respond to emerging new market opportunities, such as financial and business development services. Other complementary interventions described by DCED (2011) include access to resources that boost enterprise productivity and growth, education and health services, housing and infrastructure; reduced corruption; and the creation of social safety nets.

➢ Developing innovative financial products and services

Stein et al. (2013) discuss how existing models of credit delivery used in the private sector may provide insights that allow governments to better understand the challenges, drivers of success, and BER needed for intermediaries to work with informal businesses. Identified opportunities that deserve further research include a micro distribution and retail model that manufacturers and wholesalers use to integrate micro and small businesses into their business distribution chains; mobile money platforms to help reduce transaction costs and increase penetration rates of credit facilities in the small and informal sectors; the development of supply and value chains to help informal businesses identify new market opportunities; and the piloting of interventions targeting specific subsets of the informal economy, supporting cost-effective results. Additional research will be needed to help distinguish when a support may lead to formalization and when it will be provided only to promote enhanced productivity and incomes, leading to long-term resiliency.

The ILC (2015, para 25d) recommends the improved access to inclusive financial services, such as credit and equity, payment and insurance services, savings, and guarantee schemes, tailored to the size and needs of these economic units. For example, De Mel et al. (2011) find that when delivering an information intervention about a loan program and reducing loan guarantor requirements for largely informal microenterprises, more firms did access loans but the loans went to those with the most household assets rather than the highest growth firms. Design of financial services needs to consider the characteristics of all economic units engaged.

Similarly, the ILO (2015) recommends that attention be given to increasing finance options for MSEs. This includes establishing loan guarantee funds, increasing the availability and suitability of financial products for MSEs through commercial banks, disseminating information about financial services to MSEs, promoting innovative ways in which MSEs can use a positive credit history as collateral to
access loans at better rates and seek more competitive terms, and increasing access to low-cost business management training.

➢ Support through the social and solidarity economy

In recent years, the social and solidarity economy has emerged as a valuable mechanism for promoting firm formalization, while promoting inclusion and economic opportunity and reducing inequities. The term refers to ‘enterprises and organizations, in particular cooperatives, mutual benefit societies, associations, foundations and social enterprises, which have the specific feature of producing goods, services and knowledge while pursuing both economic and social aims and fostering solidarity’ (ILO 2009).

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<th>Box 5: Senegal tanners</th>
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<td>In Senegal in 2013, the National Federation of Independent Trade Unions of Senegal launched a programme to formalize women tanners in Guédiawaye, a suburb of Dakar, with support from the ILO. This led to the creation of the Cooperative des Tanneuses de Guédiawaye, which facilitated action planning and training of women. The cooperative provided Capacity building for members, improved occupational safety and health at work, a revolving fund, and collective purchases and sales; and obtaining a land title for the site of operation. By 2019, the cooperative has 76 members. The women engage in social dialogue with local authorities to reclaim their rights as workers. Between February 2016 and June 2017, they increased their revenues with an estimated 20 per cent. Finally, improved facilities and working conditions, as well as the use of proper protective equipment, resulted in a clean and healthy working environment for the women.</td>
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<td>SOURCE: (ILO 2019b)</td>
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<th>Box 6: Uganda Shoe-Shiners Cooperative Society</th>
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<td>Initiated by homeless street boys and girls who had, for a long time, been harassed by the city authorities for operating in the city without permit, the Uganda Shoe-Shiners Cooperative Society in Kampala was formed as a workers cooperative. Once they obtained legal status as a cooperative, they were allocated working areas in different parts of Kampala by the local authority. After a couple of years, the cooperative branched into the manufacture of shoe brushes, using environment-friendly materials such as natural wood and ox-tail bristles.</td>
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<td>SOURCE: Bibby and Shaw (2005)</td>
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Cooperatives have been shown to be an especially resilient type of enterprise and of particular value in securing livelihoods of youth and informal sector workers due to its components of member-ownership, member-control and member-use (Gicheru 2012). Cooperatives can support informal firms and even their transition to formality by facilitating their access to financial services, serving as a platform for higher level representation, providing training opportunities, securing permanent
business sites, among others (Mshiu 2010). They can also be used by independent workers or micro enterprises to organise into productive, registered entity and transition into the formal economy.

Like cooperatives, associations provide a variety of services to members. Typical functions of an association may include defending members’ legal rights, marketing for members’ industries, representing members in policy dialogues, along with other possible benefits (King et al., 2015). For example, in Kenya some associations facilitate access to insurance for members. In Ghana, associations play a broader social welfare role, protecting members from potential disruptions. These can be of value to informal enterprises that will have limited to no resources to represent themselves legally, coordinate with other firms in their industry, access social protections, etc. (King et al., 2015). Fajnzylber et al. (2006) found that for Mexican micro enterprises, participation in a business association had an impact of nine to 35 per cent higher profits.

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<th>Box 7: Case Study: Profile and Functions of Kumasi Informal Bakers’ Association</th>
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<td>Baking as a sector primarily consists of informal firms in Ghana. The Kumasi Informal Bakers’ Association (KIBA) is dominated by women, with only 20 out of 300 members being men. The association was created in 1981 to help access baking essentials for members including buying flour in large quantities. In addition to this role, KIBA now also provides training support to members and negotiation with authorities on behalf of members, such as lobbying to ensure access to materials at reasonable prices. Through these roles, many members of KIBA find it to serve as a source of social security, in some cases, their only source of social security. KIBA also works with the local government to help members formalize their activities serving as a single point of contact for the government regarding negotiation of fees, hygiene standards, tax collection from members, etc. While this has supported some level of formalization, KIBA has not been able to bring members closer together to form as a cooperative due in part to the often individualistic nature of informal sector workers and suspicion of other member firms. For this to function as it could, effort for trust building will be needed.</td>
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<td>SOURCE: King et al. (2015)</td>
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Perhaps, one of the best-known associations working with informal workers and enterprises in is the Self Employed Women’s Association (SEWA). SEWA was registered in India in 1972 with of over 1.5 million members—poor, self-employed women workers from the informal economy across 16 states in India. Another significant organization focusing on informality is Women in Informal Employment: Globalizing and Organizing (WIEGO). WIEGO is a global network focused on empowering the working poor, especially women, in the informal economy to secure their livelihoods. WIEGO promotes change by improving statistics and expanding knowledge on the informal economy, building networks and capacity among informal worker organizations and, jointly with the networks and organizations, influencing local, national and international policies.

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34 Cooperatives are defined ‘as an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically controlled enterprise’ (Mshiu 2010).
Employer and business membership organizations (EMBOs) while often having a formal sector focus, complement the work of cooperatives and associations that the members of an EMBO will have the incentive to support formalization as well, so as to spread the tax and social protection burdens across more firms (IOE, 2021). Associations and cooperatives with primarily informal members may be an important opportunity for EMBOs to expand service offerings as well, with formal firms providing supports to informal firms.

➢ Support through industry and sector clusters

Identifying and working with industry and sector clusters are a potential means to reach the informal economy. A cluster approach can help scale formalization and make technical assistance provision more efficient and more targeted (Mshi 2010; Kenyon 2007; Gicheru 2012). Clusters may help in information and skill transfer, communicating the benefits of formalization or being a part of a technical assistance intervention. Informal enterprises within a cluster may also have the incentives to report misbehaviours of peer firms that are not following the rules, addressing the draw of being a free rider and holding each other accountable.

Clusters encompass a wide range of firm agglomerations. Other subsets of clustering take on a more formal arrangement between participating firms providing many of the coordination advantages which could be particularly needed and beneficial to informal firms and workers. These other types of agglomeration include cooperatives and associations, which each take on a different legal form and provide several types of benefits to firms involved.

Production by formal firms often involves subcontracting with informal firms that specialize in a particular part of the value chain, making informal firms an often-meaningful role in the ‘production of intermediate goods, processed exports and imports, supported by supply side contracts with the formal sector’ (Mukim 2011). As a result, a cluster of informal firms may serve as manufacturing capacity for formal firms higher up the value chain.

Firms joining or considering joining a cluster face a range of potential benefits and costs, some of which are foreseen, some likely not. Clustering can lead to improved productivity and likely profitability because of technological and information spillovers, labour market pooling, supplier pooling, and reduced transaction costs, among other aspects (see Yoshino et al., 2011; Sonobe, et al., 2013).

Multiple studies have noted that relative wages within a cluster are often higher than those outside the cluster (Nadvi and Barrientos 2004; Sandee, 2002; Vissere, 1999; Nadvi, 1999). In Cambodia, Chhair and Newman (2014) found a strong positive relationship between the productivity of a firm in the cluster and that of other firms in the cluster, suggesting important productivity spillovers for informal firms that may have otherwise lagged behind.

The localization of informal firms amongst formal firms within a cluster in Kenya and Nigeria was found to benefit informal firms through subcontracting and direct sales linkages that they may not have had access to otherwise, but characteristics of formalization may reach only part way down the value chain (Mukim, 2013). Yoshino et al. (2011) reports that managerial skill development among cluster-based entrepreneurs can provide a springboard for the formalization of informal micro
enterprises. Enterprises that have recently relocated to formal upscale industrial areas in Nairobi, Kenya, benefited from direct buyer-supplier ties with multinational corporations, tended to have owners with more previous work experience in the formal sector, were older, better schooled, and more experienced as managers. Targeting training within cluster-based micro and small enterprises can lead to higher economic returns.

**Box 8: Clusters and the social economy as a tool in the COVID-19 response**

The integration of this resiliency effort with the described clusters approach may be well-suited to the COVID-19 crisis. Clusters with informal businesses are often less structured than their formal counterparts making coordination more difficult. However, coordination is most likely to develop in the face of a collective threat to the businesses’ continuation. It is at these critical junctures where policymakers seeking ways to provide support to their economies may serve a coordination role that would not otherwise have been supported by businesses. This could include collecting feedback for policy reform, direct support provision such as access to market linkages, credit needs, equipment needs, skills development, etc.

The case for engaging the social economy during COVID-19 is shown in India, where 32 per cent of informal workers received cash grants and 73 per cent of received food assistance from the government as a part of pandemic responses. However, workers who were a part of a membership-based organization and engaged with civil society organizations were more likely to have received aid of some kind – upwards of 93 per cent.

**SOURCE:** King et al. (2015); Nadvi and Barrientos (2004); India survey: Raveendran et al. (2020)

**5.3 Responding to COVID-19**

The vulnerabilities of operating in the informal economy, have been amplified through the economic shocks due to the response to COVID-19. The impact of the pandemic has been two-fold. First, those already informal firms and workers tend to be more vulnerable than their formal counterparts in terms of food security, housing stability, access to health care, connection to economic stimulus resources, etc.

Lockdowns hit informal market participants especially hard in sectors where informal firms and employment are common. Informal workers, who are often concentrated in the services sector, were more likely to lose their jobs or face large cuts in income (Balde, et al., 2020; Schotte, et al., 2021). In EMDE service sectors, about 72 per cent of firms are informal, compared with 33 per cent in manufacturing sectors (Amin, et al., 2019). Informal employees were three times more likely than their formal counterparts, and 1.6 times more likely than the self-employed, to lose their jobs during the initial COVID-19 crisis (ILO, 2021e).

Pandemic-control measures disrupted access to markets and inputs of smallholder farmers (FAO 2020) and led to the need for supply chain protection measures to keep up demand for rural small-scale farmers harvests and goods – many of which are informal. However, in addition to being less financially secure, informal workers are also less likely to have access to social protection systems designed to address income and employment instability. Reduced access to government supports
only exacerbates the economic shocks, making the most vulnerable individuals also the least supported. Informal workers also tend to have poorer access to health care, making it harder to contain the spread of the pandemic (World Bank, 2020). And similar to informal workers, firms operating informally often have less access to the type and scale of safety nets that can be accessed by formal firms (Ohnsorge and Yu, 2021).

This has pushed millions of people into extreme poverty, with impacts being disproportionately felt by women, young people and indigenous peoples (see Section 2.3 and 2.4). This has translated into dire circumstances in many cases during the COVID-19 pandemic. At the beginning of 2020, there were 135 million people worldwide facing extreme hunger. According to the World Food Program (2020), that figure may have doubled to 265 million people by the end of 2020.

Together, the scale of informal economy and the increasingly vulnerable populations has pushed policymakers to provide relief both in the short run while designing long-run plans to support movement out of extreme poverty. This includes a mix of near-term stimulus provided to individuals and businesses as well as long-term oriented policies that can support productivity and human capital gains—targeted to the informal economy—in part with the hypothesis that this may support the formal economy’s ability to absorb those previously informal workers (Bussolo, et al., 2020). However, providing near-term supports to informal workers is more difficult than reaching formal workers, given that informal workers often do not have bank accounts. This makes transferring funds less straightforward. Informal workers also tend not to pay income taxes, so the provision of tax credits is often meaningless (Caldwell et al., 2020).

### Box 9: Case studies: COVID-19 impacts

In **India** the national lockdown impacted different sectors in different ways, with some sectors suffering most significantly. For example, 99 per cent of domestic workers, 90 per cent of street vendors, 71 per cent of home-based workers and 67 per cent of waste pickers were unable to work in April 2020 due to the lockdown restriction. Domestic workers in April 2020 reported zero income while the average earnings of street vendors, waste pickers and home-based workers fell by nearly 90 per cent.

In **Peru**, similar disparate impacts are seen with youth under 35 years and women being 15 per cent and ten per cent, respectively, more likely to lose their jobs than older workers and men.

**SOURCES**: India: Raveendran et al. (2020); Peru: Cueva et al. (2020)

The second impact of the pandemic is how it has forced many previously formal activities into an at least partially informal status. Bachas, et al. (2020) use administrative corporate tax records from ten low- and middle-income countries to simulate how the COVID-19 pandemic impacts formal firm exit rates, finding a 112 per cent increase on average compared to the baseline pre-pandemic. While data is limited to isolate the extent activities are turning informal, the large rise in exit rates suggests some activities will continue but no longer a part of the formal firm. This suggests an opportunity for the informal activities to exist as a form of safety net that sustains livelihoods and household well-being, with the hope to eventually return to formalization. While the implications of falling into the informal economy are potentially damaging to one’s health, it can still serve as an option for survivalist and
necessity firms and workers to make ends meet under dire circumstances. As Ohnsorge and Yu (2021) note, in cases of a formal-economy recession, while the informal economy is shown to decline as well, it declines more slowly.

**Box 10: Examples of COVID responses**

COVID responses can include either scaling up existing social protection programs or creating new ones (ILO, 2020) which may include such supports as cash transfers and food distribution programs (FAO, 2020). Examples of efforts include:

- In Pakistan, the government is providing an additional Rs1,000 (US$6) to 4.5 million women who are existing cash-transfer beneficiaries.
- The Brazilian congress has approved a benefit of R$600 (US$120) for each informal worker and R$1,200 (US$240) to single-parent, female-headed households for three months.
- In Nigeria, the governor of Lagos announced a relief package that provides essential food delivery for 200,000 households.
- Similarly, in India, the government announced a program that provides delivery of free food for 800 million families.
- In Indonesia, subsidized vouchers are distributed to unemployed informal workers for skilling and re-skilling training.
- In Mexico, preferential loans of MXN 25,000 (USD 1,000) are provided to microenterprises in informal family businesses.
- In Rwanda, the government uses the lowest administrative entity known as ‘isibo’ that covers 15 to 20 households. Households can self-report to any committee members in the local level administrative by calling them directly or dialling a dedicated toll-free number to express their need for food.

**SOURCES:** Mukhtarova (2020); ILO (2020b); FAO (2020)

The ILO (2020c) suggests that the main objective of support to informal firms during and after the pandemic is to ‘avoid the closure of informal sector units and employment losses and enhance conditions for recovery while protecting the workers’ safety and health’. This can be achieved by ensuring at least a basic level of income security and access to healthcare for own-account workers and business owners and workers through social protection; and maintaining the economic fabric by limiting the burden of operational costs, enhancing opportunities to keep businesses afloat and maintaining a certain level of activities.

Beyond the immediate measures, governments can help to improve resilience to future shocks and lay the foundation for formalization in the medium-term. This can include many of those BER and complementary programmes previously described, but in this case, they would be implemented as a part of the COVID-19 response, with a shorter-time frame of funding but also serving as a testing ground for policies that can be continued as the COVID-19 shocks subside. For example, those informal workers, firms or sectors that have large informal components may become eligible for targeted educational programs that serve to either boost productivity in the field that was impacted by COVID-19 or support a transition to a new economic opportunity that requires reskilling. Through engagement with a formal education program, there is then opportunity to track firm progress, and build in additional financial incentives for those participants that pursue formalization. These types
of supports may help to address the economic recoveries that have started and/or faltered in many economies as regions and sectors adapt to the ‘new normal’ conditions of COVID-19 variants, stopping and starting of protective measures, and continued supply and demand shocks.
6. Policy recommendations

This chapter draws from the findings presented in the earlier chapters to identify four categories of lessons and recommendations for donor and development agencies. These categories include:

1. Focusing BERs for firm formalization;
2. Complementing programmes for firm formalization;
3. Reforms to deal with the challenges faced by informal firms and workers; and
4. Reforms resulting from the COVID-19 pandemic

Together, the following recommendations support the use of BER that is focused on the informal economy and delivered in tandem with other complementary measures. This includes reforms that aim to promote the transition of informal firms towards formalization, such as through reducing direct and perceived costs of compliance, as well as reforms that aim to address the productivity of informal business owners and their workers.

While BERs discussed here have focused on traditional tools, many aspects of those complementary programmes discussed relate closely to BE objectives, providing alternative means to improve business’ ability to grow and compete. Similarly, referring to a programme as ‘complementary’ should not belittle their potential importance – in some contexts the complementary programme may do more to support formalization than the traditional BER. As a result, given the many factors of formality, a focus only on traditional BER may obfuscate the importance of a context-specific response to the local informal economy.

6.1 Focus BER for firm formalization

- **Explicitly focus reforms on the challenges of the informal economy.** BER is as much a subject for already formal firms and workers as it is for the informal economy. Burdensome registration processes, tax requirements, labour laws, difficulty accessing financing, among other BER subjects all can lead to higher rates of informality. Given the informal economy includes upwards of two billion workers and can amount to 25 to 40 per cent of EMDE country GDP, policymakers and reforms need to prioritise and ensure they specifically focus on the challenges faced by informal enterprises and their workers. This may include and go beyond the issue of firm formalization. Thus, reform needs to be tailored to country circumstances, regional variations and sector dimensions.

- **Assess the diversity of informal business owners and workers and apply a variegated approach.** There is no ‘one-size-fits-all’ reform that leads to firm formalization. Given the varying contexts and outcomes sought by policymakers, a single tool is not necessarily readily transplanted into different economies. Formalization is not necessarily a goal for all firms and any reform must consider the heterogeneity of the informal actors. Development of a reform must understand who the reform is being targeted at. Direct engagement with stakeholders will provide rich context around rationale for compliance and perceived benefits for formalization.
• **Ensure reform packages are comprehensive rather than singular interventions to support formalization.** Informality is influenced and caused by an assortment of factors. Reforms to address informality are most impactful when done in concert with other reforms. Addressing a single cause of informality in a reform will only marginally influence the rate of informality. The full suite of investment climate variables is significant in explaining rates of informality, as is the ability of government to coordinate across relevant ministries (e.g., finance, industry, planning, labour) and the overall level of economic development. To maximize the impact of reform, policies must be implemented in a supportive institutional and macroeconomic environment which may require many reforms. Comprehensive reform should also consider synergies between reforms. For example, consider how improvements in business registration processes correspond with other obstacles that may be present in the business environment such as the extent a legal status is useful to the informal business.

• **Design reforms for supporting both formalization and related policy objectives.** Measures of BER oriented towards supporting firm formalization are strongest when also considering other social and economic objectives. Noting that formalization is an intermediate outcome to many of the desired long-term economic outcomes, plan for the long-term outcomes along with the intermediate ones. These long-term outcomes can include increased earnings for workers, increased productivity for firms, increased growth for firms, increased educational attainment for workers and their families, reduced risk of health issues and increased financial resiliency, among other objectives. Framing a BER with this lens will also help to shape design of the reform and to recognize the types of needs to be addressed amongst the informal economy. For example, incentivizing innovation in the informal economy is another complementary objective that, like formalization, can serve as an intermediate outcome towards achieving improved economic standing.

• **Apply reforms in a fair, consistent and understandable manner.** Enforcement of existing policy can increase compliance, but inconsistent application of enforcement, bribery, corruption, excessive inspection rates, and unclear rationale for government official decision-making all put enforcement efforts at risk and limit their longer-term effectiveness, reducing trust in the government, and often increasing elusive behaviour of informal firms. Reforming the governance and enforcement process may be a necessary piece of the comprehensive reform package and should be taken into consideration.

• **Bring a gender-lens to all BER development.** Disproportionate rates of informality, both as firm owners and as workers in low-income countries, means women are often faced with more vulnerable economic situations while also having greater caregiving and household duties than men. Policymakers should couple general business environment improvements with targeted efforts to improve productivity and upgrading in sectors dominated by women. BER programmes should invest in reaching growth-oriented businesses led by women, boosting their productivity. This can include targeting the most vulnerable women who have care responsibilities at home and may resort to child labour as a coping strategy. Young people and other vulnerable groups are also overrepresented in the informal economy and deserving of specific policy attention. While the obstacles experienced may not be the same
as women, policies without a youth or vulnerable group lens are likely doing less to help them, and as a result, reducing the total amount of informality that is being addressed.

- **Better regulation is one tool for supporting firm formalization but should not be the only tool used.** BER can support increased firm formalization, but other factors of formality need to be considered. For example, reforms may be utilized to support transitions to formalization by providing access to benefits that are otherwise difficult to attain as an informal firm such as access to finance, access to public markets, social security, etc.

- **Incentives of different forms and combinations can drive formalization.** While the evidence around the success of incentives is mixed, this may be due to the fact that past initiatives have insufficiently managed to identify an effective mix of incentives. When well designed, incentives can help target informal firms and an effective BE can help retain them. Effective incentives then must consider the type of firm they are serving and ensure they are not pulling firms into formality who are unlikely to stay formal or realize the benefits of formality.

6.2 Use complementary programmes when developing BE reforms for firm formalization

- **Reform design and implementation can benefit from use of complementary tools.** BER and complementary tools to reaching and engaging the informal economy are inter-connected and used to reinforce a shared outcome. While, on the one hand, countries may wish to reduce vulnerabilities in the informal sector, on the other hand, they may also want to support the formalization of informal enterprises. Thus, while they have different objectives, these need not be competing priorities. Indeed, one may lead to the other.

- **Build trust between the government and informal economy through means such as public private dialogue.** Trust between public and private sectors can drive increased tax compliance, support appropriate regulatory compliance, and reduce firm informality. While explicit discussion of trust and interventions with a clear trust orientation have been limited, the signals to date are strong and are continually supported. PPD mechanisms targeting the informal economy can work through business associations, cooperatives or clusters, using these agglomerations to hear from many firms and workers. Similarly, participatory decision-making is shown boost compliance, creating trust among informal workers that their voice is being heard. This is particularly relevant in local contexts, including when supporting local economic development. Additional research in this area may include exploring whether trust diminishes if government does not take into consideration and act on the feedback from the private sector.

- **Use behavioural insights to inform reform design and delivery.** Behavioural insights are increasingly recognized and used to frame the design and delivery of a reform to maximize uptake and support continued compliance. This includes diagnosing behavioural obstacles and designing interventions to address the obstacles. They can be used to gain insight into the decision-making process of informal firms and workers. Survey informal firms to assess their understanding of existing policy and use behavioural insights to better communicate those policy elements most important for the informal firms’ decision-making. This can
include bringing together state, non-state actors and civil society to promote normative behaviours through nudges that support compliance and formalization. Many behavioural interventions can, when well designed, be low cost, high return initiatives.

6.3 Use reforms to support those in the informal economy

- **Extend social protection to informal firms and their workers.** Social protection is associated with increased productivity. The extension of social protection can encourage formalization while also protect firms and workers in the informal economy. This is a challenge, particularly for rural workers. The design or expansion of a social protection programmes must consider the existing options for informal workers and where policy can be best placed, but access and uptake are key measures to be maximized.

- **Expand support to informal firms who lack the capacity to go formal.** When firms lack capacity to formalize, it is a signal of other vulnerabilities experienced by the owner, their families and their workers. Support informal firms in their operations through capacity building, accessing finance, market linkages, etc. to boost productivity – particularly for those firms that do not have the capacity to formalize such as necessity and subsistence firms. Capacity building support may include managerial trainings as managerial educational status is a strong predictor of the productivity of a firm and correspondingly, the likelihood the firm is formal or informal. Targeting of support to these informal firms is best done in the first few years of the informal firm’s establishment. Finally, supporting growth of informal firms may indirectly support formalization.

- **Develop innovative financial products and services.** Build an open and inclusive payments ecosystem, prioritising the development of interoperable payment systems enabling fast payments, while creating an integrated identity framework, including a ‘digital legal identity system’ to help with recognition and authentication. This includes the use of new financial inclusion technologies to transmit funds to informal workers, while creating an identity to access future resources. Reforms to boost access to financing must consider the characteristics of the firms reached and how the financing tool may create divisions within the informal economy.

- **Work with the social and solidarity economy to improve conditions for informal firms and their workers.** The social and solidarity economy can simultaneously address social informal vulnerabilities (i.e., reduced access to health care, insurance schemes, etc.) while supporting and organizing market opportunities, bargaining power, boosting productivity and wages. It may also increase the likelihood of firms realizing the benefits of formalization while simultaneously creating a more streamlined point of engagement for the government. Help to leverage the ability of cooperatives and associations to connect their members to financial and training resources as well as the influence they may have on members. Engagement with the social and solidarity economy can also help to identify those most pressing challenges for informal workers and firms.

- **Strengthen industry and sector clusters with informal firms.** Clusters are significant for facilitating improved firm performance and can create powerful normative conditions for
promoting firm formalization. Share and support input of information, innovation, and skills in clusters as they will rapidly transmit through the cluster. This will influence rates of understanding of BER, compliance, and business decision-making processes along with other policy objectives of access to social protections, higher wages, etc. Based on the assessment of challenges faced, cluster-targeted reforms may be implemented such as a new legal status or tax status for firms.

- **Develop digital solutions to engage with and deliver solutions for informal economy.** Increasing technological advancement and fintech developments have been used to drive financial inclusion for those informal workers and firms previously excluded. They are also used to communicate with the informal economy, learn about challenges, and share educational interventions. It will be important to strengthen local capacity for use of digital tools through policy reform, catalysing digital markets, and investing in digital global goods. Applying digital technologies when improving the business environment can help deliver better G2B services. In rural or hard to reach places, use of digital solutions such as SMS messaging services can be used to engage a broader stakeholder population.

- **Work with informal sector to support incremental innovations.** The informal economy can drive constraint-based innovation due to necessity firms being forced to develop new means of delivering a product or service. But risks, costs, and rapid transfer of knowledge to other informal firms limits the extent of innovation. Providing risk-reducing support, temporary stimulus funding for product development, creativity events to bring informal firms together to solve a problem, etc. may help foster incremental innovations.

### 6.4 Provide supports to the informal economy in response to the COVID-19 pandemic

- **Provide immediate assistance to both informal firms and workers to better respond and adjust to the ‘new normal’.** COVID-19 is aggravating the vulnerabilities of informal firms and workers and has made already tenuous situations considerably more dire for many firms and workers around the world. Shutdowns have led to dramatic drops in incomes, employment, health and well-being. Further, COVID-19 has driven formal firms and workers into informality. In addition to hurting the most vulnerable segments of society, formal firms have and continue to face significant financial strain and utilize informal activities and informal employment as a coping mechanism. Workers who were previously formally employed may be laid off and pushed into informal income generating activities. Measures have been implemented in EMDEs around the world to address these obstacles. These have taken multiple forms, many being cash transfers and food assistance. While the initial response to COVID-19 has passed, aftershocks are being experienced in various economies and sectors that necessitate similar types of assistance. And likewise, future economic shocks whether from COVID-19 or other causes, may require similar governments to quickly review and reimplement COVID-19 initial responses. As a result, future research on the effectiveness of responses will be critical.
• **Financial investment and human capital investment to build back should complement immediate assistance and target informal firms and workers.** Doing so should protect against future vulnerabilities, creating a foundation for firms and workers to mitigate future risks while also creating a channel for future government support to be readily disbursed as appropriate. Measures to promote opportunities for employment and business activity include new loan programs, employment match-making services, subsidizing educational programs, among many other measures. These measures can support a gradual transition to formality, serving as a point of engagement with informal firms and workers, and allowing for multiple phases of support towards formalization. These measures, while targeting informal firms are designed to support formalization in the medium-term, as opposed to the immediate assistance measures.
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