



International
Labour
Organization



- ▶ Encouraging enterprises to transition from informal to formal

Lessons for Viet Nam from the international experience*

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1.

Introduction

Asia has the second highest regional level (68.6 per cent) of informal employment (agricultural and non-agricultural) in the world, after Africa (85.8 per cent), though only marginally higher than the Arab States (68.6 per cent). Informality is not, however, distributed evenly across the region, but instead varies widely between subregions. Informality is highest in South Asia (87.8 per cent), and much higher even in South East Asia (75.2 per cent) than it is in East Asia (50.7 per cent). If China is excluded from the data, East Asia's informality almost halves to 26.6 per cent, which is hardly surprising as the other countries in the region are either high-income ones or have a very small population.

In Asia, as in every other region of the world, of the three domains where informal workers are to be found (i.e. in the informal or formal economy, or in households), the largest proportion is employed in the informal economy.

This Note discusses in brief the good practices learnt from international experience in Asia as regards the transition to formality, which should be of interest to policymakers in Viet Nam.

The Note is organized as follows. Section 2 describes the relatively good recent performance of Viet Nam as regards the transition to formality. The two sections that follow look at the international experience; in particular, examining cases drawn from countries mostly in Asia that offer valuable lessons for Viet Nam. The importance of both gross domestic production (GDP) growth and institutional development is examined, together how it influences the scale of informality in the country concerned. First, Section 3 examines the relationship between the pace and pattern of GDP growth and informality. This suggests that, while the pace of economic growth is important, it is the pattern of this growth and its labour intensity rather than GDP in itself that is more related to the extent of informality found in a country. Next, Section 4 discusses the institutional changes that have often accompanied reductions in informality.



2.

Viet Nam's performance on informality has been impressive

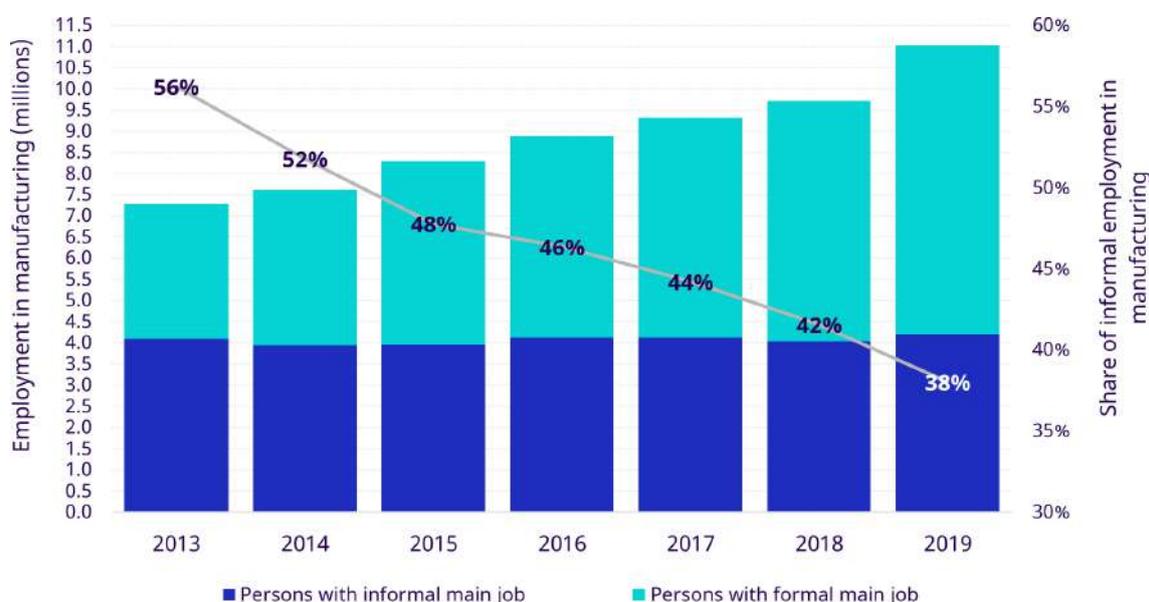
There has been a significant reduction in informal employment in Viet Nam, from 79.5 per cent in 2013 down to 67.5 per cent in 2019. There are few countries in the world able to match this record (although it must be pointed out that the evidence for time trends on informal employment, by country for other countries in the developing world, is thin and data for most countries often not available for the required duration).

With regards to the two components of informal work, informal employment in Viet Nam is falling, whereas informal work in the formal economy is increasing slightly. The reduction in informal employment is the result of strong economic growth and sectoral shifts, in particular, a shift away from agriculture to manufacturing (O'Higgins and Viegelnahn 2021).

Although the shift in employment out of agriculture includes also into services, the consequent reduction in informality is primarily due to the development of manufacturing employment. More specifically, there has been shift away from highly informal agricultural employment to less informal manufacturing. Moreover, within the manufacturing sector itself, there has also been a reduction in the prevalence of informality. However, it should be noted that this is mainly due to the creation of new manufacturing employment rather than the formalization of already existing employment (95 per cent of the "new" jobs in manufacturing are formal).

Figure 2.1 illustrates this trend by showing an increase of over 30 per cent in employment in manufacturing in 2018 compared to 2013. On average, employment in manufacturing grew by more than 480,000 for each year between 2013 and 2018. This is overwhelmingly due to an increase in formal employment in the sector. In 2018, formal employment in manufacturing increased by about 78 per cent compared to 2013, the first year for which data is available, whereas informal employment in the sector remained roughly stable.

► Figure 2.1. Employment by economic activity and informal economy (2013–19)



Source: Viet Nam's Labour Force Survey.

Despite Viet Nam's impressive recent performance, it should be regarded with caution. Firstly, there is the question of how long Viet Nam will be able to continue along this path, as future global growth is likely to be adversely affected by the COVID-19 pandemic. Moreover, despite industries moving to Viet Nam from China boosting growth, there will come a limit to the global economy's ability to absorb Vietnamese exports. (There is, of course, scope for an emerging class of domestic consumer to absorb more of Viet Nam's manufactured products.) More importantly, formal manufacturing and services employment is only a small proportion of overall employment, with two-thirds of all employment continuing to be informal. International evidence suggests that, over time, new manufacturing countries have found the share of manufacturing in GDP and employment peaking at lower levels than they did for previous generations of manufacturing countries (Rodrik 2013). The Government of Viet Nam will therefore need to be realistic in its expectations, and devise alternative strategies for increasing the formalization of workers and enterprises. This is the subject of the next two sections.

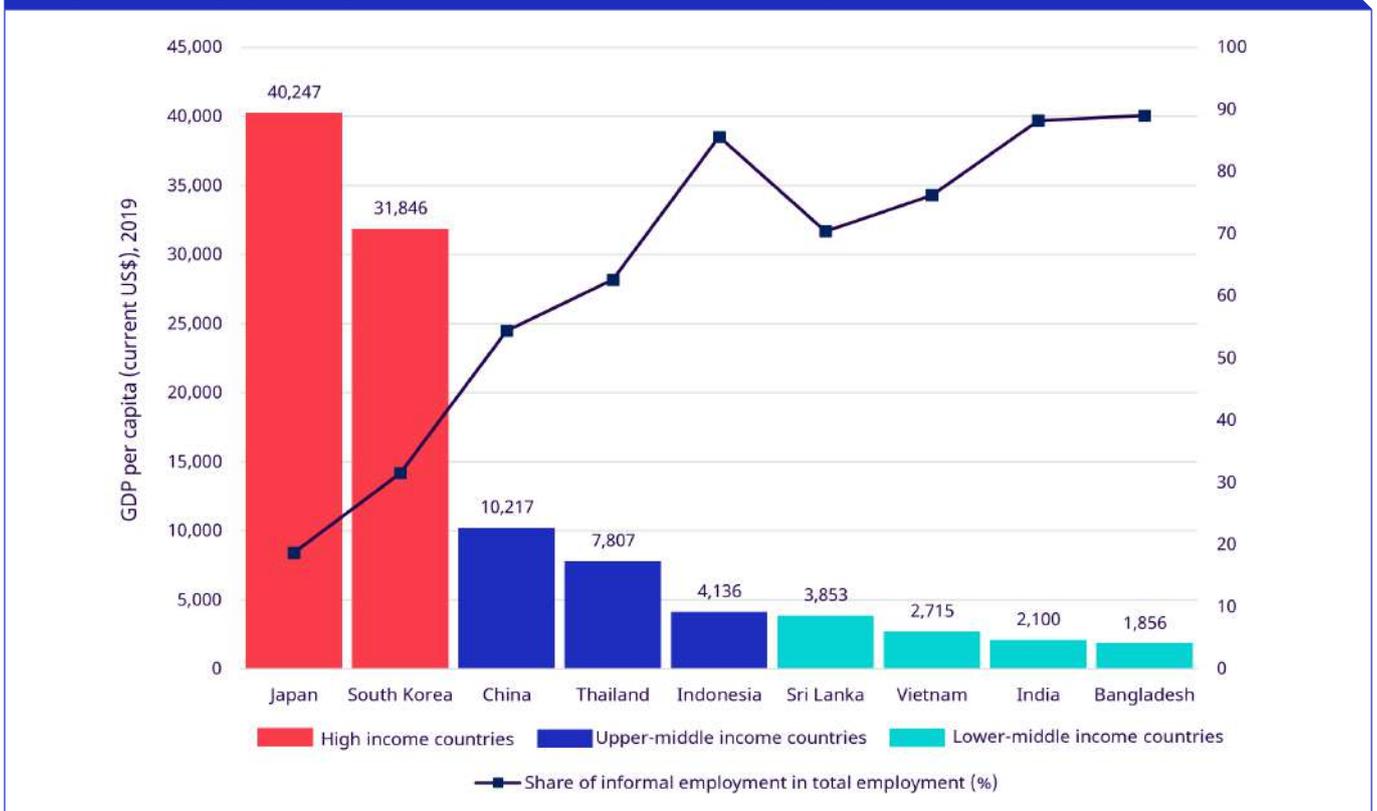


3.

Growth and informality

There are two different sets of theories in development economics to explain the extent of informal employment. One links it to the pace and pattern of GDP growth; the other focuses on institutional factors. The institutional factors concerned are not dissimilar from the ones referred to in the ILO Transition from the Informal to the Formal Economy Recommendation, 2015 (No. 204) as instruments available to promote a transition from informal into formal employment. Below each set of explanations is discussed in turn as possible instruments or drivers of a transition from informality to formality in developing countries.

► Figure 3.1. Employment by economic activity and informal economy (2013–19)



Source: World Bank and ILO database

Level of GDP and informality. The industrialized countries of the world, which are almost all high-income countries (HICs, according to World Bank classification), have very low levels of informality in their workforce (ILO 2018). Countries with a high GDP per capita (above US\$20,000 per year) have low informality rates, whereas those with a low GDP per capita (under US\$5,000 per year) tend to have high informality rates (i.e. above 70 per cent) (ILO 2018 (see figure 3.1)). Clearly, GDP per capita and the incidence of informality are closely related. This can be established on the basis of a cross section data taken at a single point in time, which suggests that, over the long term, convergence in the levels of per capita income leads to an increase in the share of formal employment. It is not inevitable, however. Moreover, below the HIC category, there is an enormous variation in the incidence of informality among middle-income countries, irrespective of whether they are lower-middle (LMIC) or upper-middle income (UMIC).¹

1. World Bank categories are based on market exchange rates (rather than purchasing power parity (PPP)). Viet Nam is an LMIC.

Growth of GDP and informality. The theoretical literature on dual labour markets, as well as the literature addressing the emergence and persistence of dualism, strongly suggests that there is little or no relationship between GDP growth and informality.² The theoretical literature in respect of dual labour markets dates from almost the same time as development economics became a discipline. The two seminal contributions to the theory of dual labour markets explaining informality, one by Arthur Lewis (Lewis 1954) and the other by Harris and Todaro (1970), continue to have contemporary relevance. However, even they do not argue that it is the pace of growth that matters when it comes to the emergence and persistence of informality. Although one model is based on classical political economy (Lewis) and the other has a more neo-classical foundation (Harris-Todaro), what matters for our purposes is that both models suggest strongly that it is the *pattern of growth* that is central to the emergence and persistence of informality. It is also what becomes apparent from this present analysis.

Structure of output and informality. A high share of agriculture in output also correlates with a high share of employment in agriculture. Agriculture in Viet Nam is still a very large part of both output and employment, despite a rapid fall between 2010 and 2019 (from 48 per cent to 28 per cent for employment). Structural transformation is a condition that can contribute to lowering informality. This is because, of all the economic sectors, agriculture is the one that normally has the highest share of informal units and workers. Therefore a lower share of employment in agriculture is likely to contribute to a lower share of informality within the economy as a whole. We have already seen some evidence of this in Viet Nam, but there are limits to this process (discussed in Section 2).

In any case, most global discussion on informality focuses on the non-farm sector, the question being: Does growth in non-farm employment increase the share of formal enterprises and formal work in the economy or not? Regarding the non-farm sector, one may ask whether there is a relationship between the share of informal units in the economy and the incidence of informality in the workforce. All the international evidence suggests that the relationship is indeed strong.

What do formal models of the development process in developing countries tell us about the emergence and persistence of informality in the non-farm sector? Harris and Todaro (1970) proposed the first formal model of informality in development economics. The Harris-Todaro model diverges from the full employment, flexible wage price models of neoclassical economic analysis by formulating a two-sector model of rural-urban migration where it was possible for a politically-determined minimum urban wage to be much higher than agricultural earnings. What distinguishes this model, they argue, is that migration proceeds in response to rural-urban differences in expected earnings, with the urban employment rate ensuring such migration is kept in equilibrium.

For Harris and Todaro, it was a politically-determined high minimum wage that led to continual rural-urban migration, in spite of substantial urban unemployment. According to their model, in the absence of complete wage flexibility, an optimal policy would comprise a package of measures which would include partial wage subsidies for private sector employment, or via direct government employment, and measures to restrict the freedom of migration from rural to urban areas. They suggest that the reasons for high urban wages may be due to unionized labour, or government policy which wants to showcase urban wages in manufacturing, with that sector offering a regular employment pension and health benefits. In fact, Harris and Todaro offer these policies as potential solutions to the problem of urban informal employment. We know that, historically, efforts to physically control migration flow from rural areas were adopted by Tanzania in the 1980s and then by South Africa during apartheid. The classic case in this regard is China's hukou system (for a brief discussion of China's strategy for containing informality, see below). From a policy perspective, it is notable that the Harris-Todaro model implies a focus on rural development, as it can not only reduce urban informal employment, but also poverty.

2. Jütting and de Laiglesia (2009) and Kucera and Xenogiani (2009) present data by region over three decades from 1975 to 2007 which shows practically no relationship between GDP growth and informal employment for any of the major regions of the world: Latin America, South and East Asia, and sub-Saharan Africa and North Africa.

It would be instructive at this point to consider the contemporary relevance of the models developed in 1954 (Lewis) and 1970 (Harris–Todaro), respectively, because they do offer policy suggestions that governments may find useful. Theoretical models need to be examined in the light of the historical experience of economic development. The example of the “East Asian miracle” economies has relevance for all regions. This is because of the large increase in the number of formal jobs created in what were newly industrialized countries at the head of the so-called “flying geese” model (i.e. Japan, Korea and Taiwan, in that order),³ which largely offset the number of rural or urban migrants. In this instance, the Lewis model provides a useful conceptual framework for understanding the dynamics of formal and informal employment in the East Asian region.

The relationship between firm size in the non-farm sector and informality. It is well known that the productivity of units and workers is higher in industry and services than in agriculture. This characterization of productivity based on differentials between economic sectors can be complemented by a characterization based on firm size, which is particularly relevant for explaining the functioning of developing economies, because it allows the analysis to include the coexistence of firms of very different sizes. Viet Nam, like most other developing countries, has a predominance of small and medium-sized enterprises (whether formal or informal), while the number of large enterprises is small. Within each sector, large firms are leaders in the process of modernization, technological improvement and so on, whereas small firms with lower productivity usually provide most of the employment; the latter also evidence greater informality.

The relationship between quality of supply of labour and informality. Lewis tended to focus on the demand side for labour (i.e. the question as to from where the demand for labour will come during the development process) but less on the supply side; specifically, the quality of labour as evidenced by the level of educational attainment of potential workers. Lewis believed that, if the human capital needed for economic development is unavailable, capitalists or the government would soon provide the facilities necessary for the training of more skilled people. Here it is absolutely critical to keep in mind that the East Asian miracle economies – and even their South East Asian neighbours who trailed the “miracle” economies in a flying geese pattern – were characterized by a significant investment in education and also vocational education and training early on in the development process. This is important, because raising educational attainment can itself affect the demand side for labour; for example, in an open economy context, by attracting foreign direct investment (FDI). Viet Nam has been very successful in attracting FDI since *doi moi* was introduced (which saw the beginning of “openness” as defined by trade/GDP and foreign capital flows), especially because its labour force is well educated, and even where skill levels are not high to begin with, they have been raised through on-the-job and pre-employment training. This is of particular relevance when highlighting the contrasting experiences of South Asian economies, especially India, which failed to attract FDI for nearly half a century, in marked contrast to China, another BRICS country. This was not only because India remained for four decades a relatively closed economy, but also because it failed to invest in school education for young entrants into the labour force.

The good news for Viet Nam is that it belongs to the category of other high-performing East Asian economies.⁴ Nevertheless, like other LMICs, Viet Nam now faces a challenge. Technological change, even in labour-intensive manufacturing, is much faster now than it in earlier industrial revolutions up until the 20th century, with Fourth Industrial Revolution technology adoption in electronics and automobile manufacturing spreading rapidly globally. Given this challenge, Viet Nam risks losing the cost advantage it derives from having an educated, reasonably skilled and inexpensive labour force, and hence losing its manufacturing growth momentum.

3. It was highlighted earlier that global production and trade has changed and that the role of export manufacturing in generating (formal) jobs is likely to diminish (Rodrik 2013). That same argument could be raised here to question whether the East Asian miracle story of industrialization of several decades ago is still as relevant in today’s global production and trade system. We would suggest that Viet Nam and other countries with lower wages will continue to attract investment within global value chain-based production networks, as Viet Nam has already done post-COVID-19, as foreign firms in China relocate to other countries.

4. La Porta and Shleifer (2014) present an interesting empirical argument based on cross-country regression analysis that finds that one key to reducing informality is not simply better education, but more specifically having better educated entrepreneurs. Such entrepreneurs are able to create and expand that type of modern business against which informal firms, despite the advantages they gain by avoiding taxes and regulations, simply cannot compete. This they argue is why the informal economy dies in the process. From this perspective, the policy message for how to grow the formal economy and shrink the informal one is to increase – whether through immigration or education and training – the supply of educated entrepreneurs.

The relationship between pattern of growth and nature of informality. Drawing upon evidence from two Asian countries, the Philippines and Thailand, Ranis and Stewart (1999) developed a model of the informal economy in which the traditional or stagnant components are in opposition to the modernizing or dynamic components, and then estimated the size of each component. Ranis and Stewart also drew attention to possible production linkages between the modernizing component of the informal economy and the formal economy. In their view, it is conceivable that GDP growth does in fact lead to an increase in the size of the formal economy, which, depending upon institutional factors, may or may not lead to growth in the informal economy. What we learn from Ranis and Stewart is that economic growth can impact the composition of informal employment in the sense that it can affect the relative size and share of traditional versus modern employment. This tends to suggest that informal employment may not simply continue but could potentially increase with economic growth in the presence of production linkages between informal and formal enterprises, as increasingly there are in a world economy comprised of global production networks and global value chains.

This has implications with regards to the growth and persistence of informality in Viet Nam. In both East and South East Asia and Latin America, globalization has effectively increased the production linkages between formal and informal enterprises.⁵ It can be legitimately argued that this process has occurred in China and Viet Nam. It is facilitated by the practice of subcontracting between enterprises in global supply chains. These can extend from a home-based worker to the contractor, which could be either an informal or a formal exporting firm in a developing country, all the way to a multinational corporation headquartered in an advanced industrialized economy (Mehrotra and Biggeri 2007). This is not surprising, as the objective of such subcontracting arrangements is to gain competitive advantage through paying lower wages, which is integral to the labour-intensive, export-oriented industries in the two countries.

Globalization can produce faster economic growth and more jobs, but it can also increase informal employment (Carr and Chen 2001). Globalization has increased competition, which, in turn, has led firms to rely increasingly on lower cost informal workers in developing countries. This is one way in which globalization generates informal employment.

The China experience. What is clear from the China growth, jobs and informality narrative is the following.⁶ First, China had a development strategy that incorporated an employment growth strategy. The outcome of the successful implementation of these two complementary strategies began has been an increase in formal work as a share of overall employment. This does not mean, however, that informality has been eliminated; far from it, plenty of informal employment remains. Two conclusions can be drawn from this: one, a growth strategy that emphasizes non-agricultural growth and facilitates the migration of surplus labour out of agriculture is a prerequisite for increasing formal work; two, the successful implementation of such a strategy may not lead to the formalization of every enterprise and every worker, even after a quarter of a century. Hence, special measures are required.

The great employment transformation in China was the result of a reasonably well conceptualized strategy of industrialization with appropriate sequencing of policies within a planning framework. The three stages would appear to have been as follows. Stage one saw the introduction of a household responsibility system at the beginning of the 1980s putting a revolution in agriculture first. This is rather similar to the other East Asian miracle economies which likewise underwent an agricultural transformation during the first decade of development (e.g. Korea, Taiwan). Stage two arrived during the same decade, with the implementation of a rural industrialization strategy characterized by a growth in township and village enterprises (TVEs). Stage three saw the growth of modern industrial sectors (Majid 2015). It had several drivers. One was FDI, mainly directed into special export zones in the late 1980s. In the 1990s, state enterprises underwent industrial restructuring, while TVEs moved from collective/state management by local government and were converted into genuinely privately-owned and managed enterprises. In addition, China carried through a concerted policy of raising (minimum) wages in order to attract workers into more productive (formal) sectors and lift living standards.

5. More research evidence on this issue would be useful, and more research could be produced in Viet Nam in this regard.

6. Formal employment in China as a proportion of total employment is 45.6 per cent, while for informal employment it is 54.4 per cent. The distribution of informal employment is as follows: 48.3 per cent in informal economy; 6.1 per cent in the formal economy; and none in the household economy. Informal units as a share of all units is 74.7 per cent (ILO database, 2018).

Nevertheless, as this Note is at pains to emphasize, the East and South East Asian experience suggests strongly that engagement in GVCs – which China and Viet Nam have engaged in successfully – also serves to entrench the existence of informal enterprises on account of the cost advantage they afford.

One can see from this analysis that the relationship between economic growth and the extent of informality within an economy is a rather complex one. Economic growth can result in an increase in absolute terms of formal employment, but at the same time it can also increase informal employment, especially in an open economy. Viet Nam has already seen a rise in the share of informal employment in the formal economy, including in manufacturing. One should not therefore look for any strong relationship between economic growth and a consistent rise in formal employment. Institutions also matter within each country – a discussion to which we now turn in Section 4.



4.

Sanctions or incentives: which is the better trigger to formality?

In this section we examine institutional reforms as instruments for converting informal firms into formal ones. We review the experience of other Asian countries, namely, Bangladesh, Pakistan and Sri Lanka in South Asia, and also Viet Nam and Indonesia from the South East Asian region. In addition, we examine two particular types of institutional reform: one involves sanctions and penalties for remaining informal; the other, incentives to encourage the formalization of informal units.

4.1. Sanctions work

Bangladesh

An experiment (i.e. impact evaluation) was conducted in Bangladesh to test whether the use of a threat (sanctions) as opposed to an incentive (or “carrot”) triggers a switch to formality (De Giorgi, Ploenzke, and Rahman 2015). The test involved informal firms being paid a visit by tax officials who handed over an official letter from the Bangladesh National Tax Authority requiring them to register with the tax authority within a prescribed time limit. It was found that many of the firms that received the letter later registered, but no such effect was seen among those firms that did not personally receive the letter, despite their being located in the same market as those that had.

In absolute terms, the intervention resulted in the registering of a small number of firms with the tax authority. However, in relative terms the effect was very large: on a base of 0.9 per cent of the firms trading in the market concerned having already been registered, the intervention led to an extra 2.2 per cent of firms registering with the tax authorities (after 84 days had passed). The second finding is that, given that there are firms of different sizes in any informal market, only those firms with higher revenue registered (this result was statistically significant).

This example from Bangladesh suggests that instead of trying to formalize every informal enterprise, the government would do better to focus attention instead on the larger units in the informal economy. The big takeaway from this research is that sanctions are effective as a trigger for informal firms to formalize.

Another field experiment by De Giorgi and Rahman (2013) randomized an information campaign to groups of firms in an effort to reduce registration costs. It was found that those firms in receipt of the information became more aware of business registration procedures, but the programme itself made no impact on actual registration.

Pakistan

In Pakistan, a randomized control trial was conducted in the Punjab by the Pakistan provincial government (Khan, Khwaja, and Olken 2014). Tax officials working in the province’s urban property tax department, consisting of 482 property tax units (known as “circles”), were randomly assigned to one of three different performance-related pay schemes or else a control group. A total of 218 circles, consisting of about 550 tax personnel, were randomly assigned to one of the three schemes for a period of two fiscal years. The incentives on offer to tax personnel were substantial: the three-person tax team in each circle treated was collectively given an average 30 per cent of the revenue collected over and above an historic benchmark. Many of the tax teams offered incentives were able to double, or more than double, their baseline salaries.

7. ILO Recommendation No. 204 suggests possible actions to be taken for a transition into formality. Under Article 25 of Recommendation No. 204 are listed: a) business entry reforms; b) simplified tax and contributions assessment and payment regimes; c) access to public procurement; d) access to inclusive financial services; e) access to entrepreneurship training, skills development and tailored business development services; and f) access to social security coverage. These six actions are potential triggers in the transition from informal into formal units. As they do not apply to Viet Nam specifically, they are not discussed in this Note.

The three performance-related pay schemes varied in respect to the extent to which the intervention-based performance pay was based on revenue outcomes and the extent to which they allowed for subjective evaluation on the part of the tax department.

There were notable differences between the schemes in terms of impact on revenue, with only relatively small differences in taxpayer satisfaction and perception of the tax department. Specifically, the Revenue scheme, which provided incentives based solely on revenue collected, showed annual revenues 15.2 log points higher relative to controls (57 per cent higher growth rate) by the second year. The Revenue Plus scheme achieved only 8.1 log points, and the Flexible Bonus scheme only a statistically insignificant 3.5 log point increase in current-year revenue.

This example makes it clear that incentivizing officials increases the amount of tax revenue collected from registered firms.

The lesson to be drawn from this example with regards to formality is that there is a role to be played by labour or tax officials who are currently only focused on small formal enterprises (while conceivably extracting bribes from informal ones). If performance pay were to be linked to the number of informal firms that decide to register with the tax authorities, it is possible that the number of registrant firms would increase overall. However, the design of such a scheme is critical in order to prevent this measure having the unwanted effect of incentivizing tax officials to harass micro-entrepreneurs; the tax collection trial in the Punjab is a good model in this respect.

Brazil

A similar study in Brazil examined the effect of stricter enforcement on formalization (de Andrade, Bruhn, and McKenzie 2013). It evaluated the effectiveness of providing information about registration and the payment of registration costs, threatening firms with an enforcement visit from a municipal inspector and threatening neighbouring firms with an inspection. Enforcement was found to increase the likelihood of registration, but that the other treatments made no impact. In addition, a neighbouring firm being inspected did not prompt other firms to register. According to the study, "These findings suggest that sanctions rather than incentives may be more effective at getting firms to formalize" (p. 2).

India

The majority of organized or formal units in India are indirect taxpayers, whereas most unorganized units are not. An indirect tax reform starting 1 July 2017 introduced a nationwide Goods and Services Tax (GST) in lieu of state-level VAT or value-added taxes and is transforming many informal economy enterprises into formal ones, to the extent that enterprises now have an incentive to register with the GST authority.

Why has GST proved to be a game-changer? The main reason is its provision of an input tax credit (ITC), the underlying premise of which is that taxing the same thing twice is unfair. To avoid double taxation on items used as inputs to make other items, credit for tax paid on inputs can be claimed by the maker of the next item who pays then tax on the output. If the tax paid on inputs is higher than the tax paid on outputs, the excess can be claimed as a refund. ITC is also available to traders on goods bought for sale or resale; and, because many small traders in unorganized, informal units purchase goods from formal, organized sector enterprises, they have an evident self-interest in registering with the GST authority. This does not make them fully formal, but they do thereby become taxpayers and take a first step towards further formalization which can be initiated either through state action or by the firm itself (Ministry of Finance 2018).

4.2. The evidence on the use of incentives as an instrument of formalization

Most government support programmes for the informal economy target individuals rather than firms. This does not encourage informal firms to formalize and thereby benefit from support programmes (de Paula and Scheinkman 2007). However, informal firms are more likely to register as formal firms, if the benefits of formalization, such as tax incentives, soft loans and government support for human resource development and technology, are greater than the costs (e.g. registration fees or other payments during the registration process).

Viet Nam

The drivers of firm formalization are the subject of a recent study undertaken in Viet Nam (Nguyen, Verreynne, and Steen 2014) using data from the “Small and Medium Scale Enterprise Survey in Viet Nam” conducted in 2005, 2007, 2009 and again in 2011. The latter surveyed around 2,600 manufacturing firms in three cities in each of the four years covered. The three cities concerned were Ho Chi Minh City, Hanoi, Haiphong and seven rural provinces, namely, Nghe An, Long An, Ha Tay, Quang Nam, Phu Tho, Khanh Hoa, and Lam Dong. For each of the years surveyed, a stratified sampling method was employed to ensure representativeness across all types of enterprises that included firms operating under the Enterprise Law and Cooperative Law, and therefore considered to be formalized firms, as well as household firms not operating under these laws, and therefore considered to be informal firms.

Asking what makes informal firms transition into formalized firms, results show that the transition process benefits from government-supported finance. Such support encourages firms to enter the formal economy rather than bear the costs associated with remaining informal. Moreover, government-financed support for businesses to transition into formalization can lead to two positive outcomes: first, by loosening growth constraints for businesses; and, second, by enforcing the property rights of businesses that register and so gain the full benefits of accessing credit and skilled labour. In addition, corruption within the economy is seen to reduce with increased participation in the formal economy.

Furthermore, the results of a study by Nguyen et al. (2014) corroborate a proposed link between government support and formalization in that it found that government support for informal firms makes them more likely to formalize as structural attention drives decision-makers to weigh the costs of informality against the benefits of operating in the formalized economy. Structural attention, the study claims, is enacted through a network of distributed actors in the broader economy and the institutions of the public sector. Consequently, informal firms are motivated to formalize in order to improve growth.

While firms in Viet Nam can access support through investment incentives, tax exemptions or reductions, or soft loans from the Vietnam Development Bank or Vietnam Bank for Social Policies, only formalized firms can apply for investment incentives, tax exemptions or reductions. In contrast, informal firms are only able to access a small number of soft loans from these two same banks via their focus on poverty alleviation rather than for business development.

Sri Lanka

A field experiment conducted in Sri Lanka provided incentives for informal firms to formalize (de Mel, McKenzie, and Woodruff, 2012). It showed that only offering information about the registration process and reimbursing direct registration costs made no impact on formalization. Adding payments equivalent to one-half to one month's profits for the median firm led to the registration of around one-fifth of firms. A larger payment equivalent to two months' median profits induced half of firms to register. The main reasons for not choosing to formalize when offered incentives included issues relating to ownership of land and concerns about being faced with labour taxes in the future. The authors also found that the degree of bureaucracy in the registration process seems to matter for those with an incentive to register, with response to incentives higher in Colombo, where the registration process was easier, than in Kandy, where it was more difficult.

There is other, more recent experimental evidence on the effectiveness of programmes that reduce registration costs in encouraging formalization. In a field experiment, de Mel et al. (2012) randomly lowered information costs and increased the monetary benefits of formalizing for firms. The main finding is that providing information about how to register and paying firms' registration costs were insufficient to persuade firms to register. Rather, to induce firms to register, substantial monetary reward is required, in addition to simply covering the direct costs of registration.

India

The Government of India is actively encouraging formalization through incentives (which are currently on-going interventions). Two types have been made available. The first relates to all firms with more than 20 employees and therefore required to enrol employees in the country's Employees' Provident Fund Organisation (EPFO), a social security scheme that pays out a lump sum to workers upon retirement in lieu of a pension.

Historically, evasion of the EPFO by employers has been widespread, given the poor enforcement of labour laws. The present government, in an effort to formalize employment, has incentivized employers to enrol workers under the EPFO by offering to pay the employer's contribution to scheme for three years in order to boost enrolment.

Maharashtra state (in western India), for instance, as an additional labour welfare measure, has widened the remit of the EPFO to include all power-loom workers (irrespective of the size of the enterprise), thereby boosting formal economy employment. Such measures, howsoever temporary, may enlarge the formal economy. Since September 2017, EPFO registration data for the state has been released showing half a million new workers being registered each month, which means an equivalent number of formal jobs being created every month. Although these are, of course, not new jobs, it makes a big difference to the overall well-being of those workers registered. This process does seem to have contributed to a reduction in informality among formal firm workers; however, the majority of informal workers employed in informal firms remains untouched by such benefits.

A second action taken by the government relates to public procurement from micro-, small and medium-sized enterprises (MSMEs), but only from those that are registered. The MSME Development Act, 2006, specifies Micro-Small-Medium thresholds by size of capital investment. Preference is shown to these enterprises in government procurement. The Public Procurement Policy, 2012, states that central government shall procure a minimum 20 per cent of the total annual value of goods and services from MSMEs (made mandatory as of April 2015). Of this 20 per cent of annual procurement, 4 per cent is earmarked for the lower-caste Scheduled Tribes and Caste-owned MSMEs, and a procuring entity has to include procurement compliances in its annual report. An MSME quoting a price within the price band L1+15 per cent will qualify as a supplier if it adjusts its price to match L1 (lowest bidder) price.

4.3. Social insurance for informal workers

ILO Recommendation No. 204 makes a series of recommendations about what can be done to promote the formalization of workers (as opposed to that of enterprises) (see footnote 8). We present here two examples of success, one from Thailand and another from Viet Nam. In both countries, informal workers in the informal economy, and even those in formal firms, do not have access to social insurance (old-age pension, death/disability insurance, maternity benefits).

Thailand

Thailand has 21 million informal economy workers. It has a total of 15 million insured people under its social insurance system.

Since 1990, a formal economy pension has been in place for those aged 55 or over. The government's contribution to the scheme used to be 1 per cent of the insured person's monthly earnings. However, since 2011, a much more inclusive pension scheme that also covers the informal economy has been in operation, based on a National Savings Fund. The self-employed make contributions towards their pension on a voluntary basis to the amount of 100 Thai baht (THB) a month. In addition, 50–100 per cent of an insured person's contribution, depending on age, is contributed by the government. As a result, coverage of the workforce is now 36 per cent under contributory/mandatory schemes and an additional 39 per cent under contributory/voluntary schemes. The rest of the population is covered by a non-contributory scheme. The total cost of the scheme in the form of social assistance is met by the government.

In Thailand, a universal non-contributory old-age allowance provides some protection to people without a regular pension. The monthly benefit is tiered and varies between THB 600–1,000, equivalent to US\$18–30, which is below the national poverty line by more than a half. The allowance is the only form of pension for many people working in the informal economy. To encourage participation in its contributory system, the government makes an equivalent contribution.

The Homeworkers Protection Act was adopted in September 2010 and a milestone in terms of extending labour protection and formalizing the homework sector, and involves around 2 million workers in Thailand. The Act defines "homework" to mean work assigned by a hirer in an industrial enterprise to homeworkers to produce or assemble outside of the hirer's workplace or other works specified by the ministerial regulations.

Viet Nam

A study has investigated how social security provision – a key determinant of formality – impacts on small and medium-sized firm performance in Viet Nam (Lee and Torm 2017). Based on enterprise census data covering firms registered from 2006 to 2011, the authors find that those firms that increase social security coverage by 10 per cent experience a revenue gain of 1.4–2.0 per cent per worker and a profit gain of up to 1.8 per cent, depending on the survival time of the firm. However, given the time lag between "investment" (in social security contributions) and returns (enhanced firm performance), specific policy measures, such as initial social insurance subsidies for small firms, could enhance participation in mandatory schemes.

Given the positive developments in both these South Asian and South East Asian nations, formalization of workers through the provision of social insurance could transform the landscape of informality across a region that has among the highest informality rates of any region of the world, outside of sub-Saharan Africa.

There is other, more recent experimental evidence on the effectiveness of programmes that reduce registration costs in encouraging formalization. In a field experiment, de Mel et al. (2012) randomly lowered information costs and increased the monetary benefits of formalizing for firms. The main finding is that providing information about how to register and paying firms' registration costs were



5.

Summary and conclusions

1. It is not inevitable that formality should arise out of GDP growth; informality exists even among high-income countries. Moreover, below the HIC category of countries, there is enormous variation in the incidence of informality among middle-income countries, irrespective of whether they are low (LMICs) or upper middle-income (UMICs).
2. Growth is an important determinant of informality, which is likely to increase in its absence. It is not, however, sufficient in itself to reduce informality. What matters most is the pattern of growth, as the varying experiences of LMICs and UMICs demonstrate.
3. Structural transformation is a condition that can contribute to the lowering of informality. Because agriculture normally has the highest share of informal units and workers of any economic sector, a lower share of employment in agriculture is likely to contribute to lowering informality.

The non-farm sector is the focus of most global discussion on informality. International evidence suggests that in the non-farm sector there is a strong link between the proportion of informal units in the economy and the incidence of informality within the workforce.

Within each sector, whether industry or services, large firms lead the process of modernization, technological improvement and so on, but it is small firms with lower productivity that usually provide most employment. Greater informality is also evident in small firms. Therefore, an economic environment that allows small firms to grow on a sustained basis is critical to reducing informality, while also raising productivity in the economy.
4. According to the theoretical literature, if the human capital needed for economic development is not available, capitalists or the government would soon provide the facilities necessary for the training of more skilled workers. The East Asian miracle economies, and even their South East Asian neighbours whose development followed the “miracle” economies in a flying geese pattern, were characterized by a significant investment in education and also vocational education and training aligned with an industrial strategy. This is important, because increasing educational attainment can itself affect the demand side for labour; for example, in an open economy context, by attracting FDI.
5. Both in East and South East Asia, and Latin America, globalization has fostered production linkages between formal and informal enterprises. It can be legitimately argued that this is what has happened in China and Viet Nam. It comes about through the practice of subcontracting between enterprises in global supply chains and has tended to increase informality.
6. Institutional reforms are instruments for converting informal firms into formal ones. They can be either in the form of sanctions (i.e. by imposing costs on informal firms for remaining informal) or incentives to switching to become formal.
7. Because there are size differences among units within the informal economy, some evidence suggests that instead of trying to formalize every informal enterprise, the government would do better to focus its attention on the larger units in the informal economy. The big takeaway from this research is that sanctions work as a trigger for informal firms to formalize.
8. Other evidence in institutional reforms suggests the following. There is a role to be played by labour or tax officials who often only focus on the small enterprises that are currently formal (while conceivably extracting bribes from the informal ones). If performance pay for officials were linked to the number of informal firms deciding to register with the tax authorities, it is possible that the number of registrant firms would increase as a result.

11. When informal firms see a financial gain to becoming formal, they become interested in registering with formal institutions, whether it be with tax institutions or other authorities. This has the advantage of increasing the government's tax revenues; but, for the purpose of formalizing firms, registration should be seen as a first step towards full formalization, including of workers.
12. Government-financed support for businesses to transition into formalization can lead to two positive outcomes: first, by loosening growth constraints for individual businesses; and, second, by enforcing the property rights of businesses when they register and so gain the full benefits of accessing credit and skilled labour. Viet Nam's experience bears this out. In Viet Nam only formalized firms can access support from the Vietnam Development Bank or Vietnam Bank for Social Policies through investment incentives, tax exemptions or reductions, or soft loans. In contrast, informal firms are only able to access a small number of soft loans from these two banks for poverty alleviation alone, rather than business development.
13. There is recent experimental evidence as to the effectiveness of programmes that reduce registration costs. Providing only information about how to register and a paying firm's registration costs were an insufficient inducement for firms to register. To cause firms to register, firms needed to be provided with substantial monetary compensation, in addition to the covering of the direct costs of registration.
14. Government subsidies for the cost to an employer of registering workers for social security helps. Governments have been encouraging formalization through incentives. One type of incentive made available relates to firms in India that have more than a certain number of employees and therefore required to register employees in the Employees' Provident Fund Organisation, which pays out a lump sum in lieu of a pension upon retirement.
15. There are other means of encouraging voluntary schemes to register informal workers for social insurance. Evidence shows that Viet Nam's scheme is too expensive for own-account workers. If a government subsidizes informal workers in joining an existing formal social insurance scheme (or even designs a separate scheme for informal workers), international evidence indicates such a subsidy is likely to increase the number of self-employed workers registered in social insurance programmes.
16. This Note references several times ILO Recommendation No. 204 with regards to the measures needed to facilitate the transition from informality to formality. One of the Recommendation's key points is the importance of adopting an integrated approach when tackling informality instead of discrete, disconnected interventions. All countries need to bear this in mind, and that the lessons summarized here need to be pursued in an integrated manner.

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