



International
Labour
Organization



Policies, Strategies and Practices for the Formalisation of Micro and Small Enterprises

Introductory Brief – Enterprise Formalization



Copyright © International Labour Organization 2016

First published 2016

Publications of the International Labour Office enjoy copyright under Protocol 2 of the Universal Copyright Convention. Nevertheless, short excerpts from them may be reproduced without authorization, on condition that the source is indicated. For rights of reproduction or translation, application should be made to ILO Publications (Rights and Permissions), International Labour Office, CH-1211 Geneva 22, Switzerland, or by email: pubdroit@ilo.org. The International Labour Office welcomes such applications.

Libraries, institutions and other users registered with reproduction rights organizations may make copies in accordance with the licences issued to them for this purpose. Visit <http://www.ifrro.org> to find the reproduction rights organization in your country.

International Labour Office; Enterprises Department

enterprise creation / enterprise formalization / social dialogue / sustainable development / informality / global

The designations employed in ILO publications, which are in conformity with United Nations practice, and the presentation of material therein do not imply the expression of any opinion whatsoever on the part of the International Labour Office concerning the legal status of any country, area or territory or of its authorities, or concerning the delimitation of its frontiers.

The responsibility for opinions expressed in signed articles, studies and other contributions rests solely with their authors, and publication does not constitute an endorsement by the International Labour Office of the opinions expressed in them.

Reference to names of firms and commercial products and processes does not imply their endorsement by the International Labour Office, and any failure to mention a particular firm, commercial product or process is not a sign of disapproval.

ILO publications and electronic products can be obtained through major booksellers or ILO local offices in many countries, or direct from ILO Publications, International Labour Office, CH-1211 Geneva 22, Switzerland. Catalogues or lists of new publications are available free of charge from the above address, or by email: pubvente@ilo.org

Visit our website: <http://www.ilo.org/publns>

Produced in Switzerland

1. Introduction

The International Labour Organization (ILO) is focused on the creation of full and productive employment and decent work for all, yet the presence of a large and sometimes growing informal economy presents a significant challenge to this work. There are a wide range of varying economic, social and political factors that affect the size and nature of the informal economy. This makes it difficult to develop a single response that can be applied in all countries and regions. This Introductory Brief has been prepared by Simon White to synthesize some of the most significant, recent findings in this field including a series of regional and thematic briefs and to present this in an easy to digest summary of the key issues and approaches.

The Brief draws from the work of the ILO around the world, from other relevant evidence in the field as well as from a workshop with constituents on enterprise formalization held in Turin, on September 10th and 11th 2015. While informality deals with a wide range of informal activities, enterprises and jobs, this document focuses on the informal enterprise, which can be broadly defined as an unincorporated small or unregistered enterprise (ILO 2003, 2013). The central concern is with the policy reforms and programs that can be introduced to encourage these enterprises to become more formal. A process described as “formalisation”. The Brief has been prepared for ILO Officials in charge of assisting ILO Constituents in formulating policy recommendation related to enterprise formalization,

government representatives working on enterprise development policy and programming, representatives from ILO’s constituents.

The informal economy comprises around half of the workforce worldwide. This equates to employment that is unsafe, precarious, unprotected, poorly paid, and under represented at a massive scale. While informality can be found in enterprises of all sizes, this Brief is concerned with micro and small enterprises (MSEs), which represent the bulk of informal employers in developing and transition economies.

While the nature of informality makes it difficult to measure and monitor, the ILO (2013) produced a statistical profile of informal employment around the world.¹ While there are significant variations in the scale and type of informality found in countries and regions, in more than half of the countries surveyed, the proportion of people in informal employment in non-agricultural activities exceeds 50 per cent and in about one-third of the countries surveyed, informal employment accounts for at least 67 per cent of non-agricultural employment. In all except two countries, the number of persons employed within the informal sector exceeds those in informal employment outside the informal sector, suggesting that the bulk of informal employment is concentrated in employment in the informal sector.

One of the ways to reduce the size of the informal sector is by stimulating the

1 This distinguishes between “informal sector employment”, which includes women and men who are employed by informal enterprises, and “informal employment”, which covers workers who are informally employed by formal enterprises.

formalization of informal enterprises. In the literature, informal enterprises are usually characterised in terms of the primary objective of the entrepreneur, the production factors involved and the organization of the production process, including the legal form of the enterprise, its registration status and its compliance with different regulations with regard to labour conditions. Informal enterprises are usually defined in terms of lack of compliance with government regulations, in particular regarding registration, payment of taxes and social contributions, and labour regulations. They are also considered to be micro or small in terms of their size, which is typically measured in terms of the number of employees.

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 the public authorities. This drew the attention of the ILO and other 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 program 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) discussed this topic at length. In this discussion, the Conference adopted the more encompassing and

descriptive term of “informal economy” to refer to all economic activities (i.e., not just “economic units”) that are not covered or insufficiently covered by formal arrangements, either in law or in practice. Informal economic activities operate outside the formal reach of the law or 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*”.

In 2015, the ILC adopted Recommendation 204, known as the “Recommendation Concerning the Transition from the Informal to the Formal Economy”, to guide Members in their efforts to facilitate the transition of workers and economic units from the informal to the formal economy, promote the creation, preservation and sustainability of enterprises and decent jobs in the formal economy, and prevent the ‘informalisation’ of formal economy jobs.

In doing this, the following principles were agreed to (Para 7):

- a. Diversity of characteristics, circumstances and needs of workers and economic units in the informal economy, and the necessity to address such diversity with tailored approaches;
- b. Specific national circumstances, legislation, policies, practices and priorities for the transition to the formal economy;
- c. The fact that different and multiple strategies can be applied to facilitate the transition to the formal economy;
- d. Need for coherence and coordination across a broad range of policy areas in facilitating the transition to the formal economy;
- e. Effective promotion and protection of the human rights of all those operating in the informal economy;
- f. Fulfilment of decent work for all through respect for the fundamental principles and rights at work, in law and practice;
- g. Up-to-date international labour standards that provide guidance in specific policy areas;
- h. Promotion of gender equality and non-discrimination;
- i. Need to pay special attention to those who are especially vulnerable to the most serious decent work deficits in the informal economy, including but not limited to women, young people, migrants, older people, indigenous and tribal peoples, persons living with HIV or affected by HIV or AIDS, persons with disabilities, domestic workers and subsistence farmers;
- j. Preservation and expansion, during the transition to the formal economy, of the entrepreneurial potential, creativity, dynamism, skills and innovative capacities of workers and economic units in the informal economy;
- k. A balanced approach combining incentives with compliance measures; and
- l. Prevent and sanction deliberate avoidance of, or exit from, the formal economy for the purpose of evading taxation and the application of social and labour laws and regulations.

These principles provide a valuable guide for policy reformers who wish to encourage the formalisation of the informal economy. It is from this perspective that the approaches to policy reform are considered. In the next section, an overview of policy reform interventions is presented. The use of

these is dependent on a clear diagnosis of the causes of informality. Following this, a set of practices for reformers is outlined; demonstrating that policy reform in this field involves a distinct set of challenges to the way reform is done. Finally, a series of lessons learned are elaborated.

2. Policy Responses to Informality

The Donor Committee for Enterprise Development (DCED 2011) suggests there are two broad policy responses to informality. The first focuses on improving the conditions in which informal enterprises operate and employ workers. Because “informal economic activity can promote innovation and can act as a buffer to economic shocks that developing economies regularly face” it is argued that reforms can “enhance the positive effects of informality while making it safer, protecting the vulnerable, and encouraging equity”.² Indeed, a “dynamic, competitive, and growing economy will display movement between the formal and informal economies”. The second policy response is the most favoured and is concerned with ways of encouraging informal enterprises to formalise (i.e., so that unregistered and unlicensed firms become registered and licensed). These reforms informal actors transition to become formal and to participate more in the mainstream, formal economy, including the global economy. Formalisation endeavours to encourage MSE owners and managers to invest more into their enterprise and its workers so that the enterprise becomes more sustainable and competitive, contributing to achieving full and productive employment and decent work for all.

Designing a policy response to informality is based on an assessment of its causes. This section summarises the major contributors to high levels of informality in developing and transition countries, and outlines the kinds of policy responses that can be taken to address this. In general, it should be recognised that informality is the result of a combination of economic, social and political factors.

2.1 Causes of informality

The causes of informality vary. Policy reforms that promote formalisation need to be designed based on a clear diagnosis of prevailing forces that shape informal economy. This is likely to include an assessment of the following general causes:

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

- **Poor general business environment:** Many developing countries have business environments that are difficult and costly to comply with. Instead of being short, simple and cheap, regulations are numerous, lengthy, and expensive. These conditions contribute to increasing the cost of doing business in the formal economy and, which can reduce productivity and competitiveness.
- **Few incentives to formalise and poor government services:** Many informal MSEs associate formalisation with high regulatory burdens and harassment. While harassment by the police and various other officials is a common experience for informal enterprises, it is often treated as a cost of doing business informally and not as great as the costs that come with formalisation. Informal enterprises fear that by registering or obtaining the licenses and permits they officially require, they will become more visible to government and subject to increasing costs. Furthermore, formalisation in developing countries does not usually bring more government services. Enterprises operating in poor areas are typically subject to regular power outages, the lack of rubbish removal, and ailing infrastructure, whether they are registered or not.
- **Exclusion and marginalisation:** Certain groups, such as women and indigenous peoples, are disproportionately represented in the informal economy, as a result of social conditions that exclude or marginalise these groups making it more difficult for them to engage in formal markets.
- **Poverty and unemployment:** High levels of poverty and unemployment force men and women into starting an enterprise as the last, and only, resort. These people are in business to survive and rarely do they consider the legal or regulatory consequences of their actions. Indeed, while they may be running an informal enterprise for many years, many of these people will immediately stop running a business in a decent work opportunity became available.
- **Informality due to conflict and other forms of social disruption:** Informality can be caused by external shocks and social disruptions that create instability and force people to operate outside of the formal legal system. This includes the experience of armed conflict, famines, and natural disasters where the rule of law is weakened and informal behaviour increased.
- **Reducing costs and maximizing benefits:** Many informal MSEs trade off the costs of formalisation with the benefits. Many countries with large informal economies make it difficult to formalise and offer few benefits.
- **Poor enforcement mechanisms:** Informality can stem from an environment in which law and regulations are not enforced or, where they are enforced, are not enforced based on clear rules and procedures. Local government officials, tax inspectors and other kinds of officials in these situations have a high degree of discretion and can choose to interpret laws and regulations as they see fit. This does not build confidence in the legal system and encourages enterprises to respond strategically as and when these situations arise.



The ILO (2014) illustrates how the various causes of informality can be used to develop a policy response. In Figure 1, four common causes to informality found in Latin America and the Caribbean are presented, accompanied by possible responses.

Figure 1: Causes of informality and strategies for MSE formalisation

Low productivity and high costs of formalisation	
	<p>Promoting productivity in MSEs</p> <ul style="list-style-type: none"> ▪ MSE development policies (access to markets, finance, technology) ▪ Association building, cluster development, local economic development
Complex procedures, inadequate regulation for the size and characteristics of MSEs	
	<p>Revision/adaptation of regulations, procedures and norms</p> <ul style="list-style-type: none"> ▪ Simplification of administrative procedures ▪ Differential regulations
Informality as an attractive option: flexibility and independence	
	<p>Incentives to formalise</p> <ul style="list-style-type: none"> ▪ Access to social security ▪ Access to public procurement ▪ Access to financial and business services
Limited inspection, state and social control	
	<p>Enhancing the capacity to enforce compliance</p> <ul style="list-style-type: none"> ▪ Inspection with technical assistance ▪ Unique identification numbers ▪ Effective sanction systems ▪ Institutional coordination

SOURCE: International Labour Organization (2014a)

2.2 Policy responses

The ILO (2014a) says it is important to make a distinction between the goal of formalising business entities and formalising employment. Although strong correlations exist between the two, the results of certain policies on one domain or the other may be uneven (e.g., policies to promote business registration do not necessarily generate the desired results in terms of formal employment and compliance with labour regulation).

There are a number of policy domains that affect the prospects of informal firms to formalise. These are summarised

below. The broad intention of reform in these domains is to discourage informal behaviour and to encourage MSE owners and managers to invest in their enterprise and its workers.

Business registration and licensing

Because informal enterprises are typically considered to be unregistered and unlicensed, logic suggests that reforms that make registration and licensing easier and cheaper would have a direct effect on the process of formalisation. Indeed, the ILO (2014a) argues that these reforms should be an “important cornerstone of any agenda” to formalise MSEs. The most

common strategies for doing this include reducing or consolidating the number of steps required to register, simplifying administrative processes for licensing, reducing or eliminating minimum capital requirements, administrative deadlines and positive administrative silence, and digitising the process and using on-line facilities. Initiatives in this field have also included the creation of one-stop-shops and establishing simplified legal formats for micro businesses.

As important as these reforms are, it should be recognised they may not be enough. A number of reviews and evaluations in recent years have found that improving business licensing and registration does not, on its own, appear to work as a strategy for formalisation, at least in terms of the number of businesses registered and licensed.³ Thus, other reforms are needed to complement and bolster these efforts.⁴

Taxation policy and administration

Inappropriate taxation systems have been found to encourage informality. Many MSEs fail to comply with the tax system because it is too complex, expensive and opaque. In many cases, MSEs are simply not aware of their tax obligations or fearful of the tax system. A desire to avoid tax is often at the heart of the decision to not register or obtain the necessary licences. Tax compliance can be eased by introducing more transparent and simplified tax reporting requirements,

improving tax inspections, reducing the number of payments, offering different payment options, and differentiating tax schemes for microenterprises and farmers. Tax policy reform typically involves reducing the complexity of procedures and the multiplicity of taxes, while addressing the lack of information about tax obligations. Reform strategies include the introduction of special tax regimes for MSEs, the simplification of accounting standards, reporting requirements and payment facilities within the general tax regime, providing better information and technical assistance to enterprises, and improving inspection to reduce tax evasion.

The ILO (2014a) recommends that tax reform respond to variations in firm size. Where micro-enterprises operating at subsistence level might benefit from a single fee payable to the local municipality, larger enterprises that are still small in the overall spectrum of enterprise size, should be required to pay taxes, but could benefit from special schemes. More established small enterprises should be incorporated into the general tax regime, where they could possibly benefit from a simplification of the system. The transition from one regime to the other should be as smooth as possible.

Several countries have created special tax regimes for MSEs to promote formalisation, support small enterprise development and allow greater administrative efficiency in tax collection (e.g., Colombia, Brazil, Mongolia, see ILO 2015a, 2014b,d). These schemes typically provide lower tax rates, presumptive taxation methods, and the integration of different taxes into

3 See Warner (2012), Fajnzylber and Montes-Rojas (2011), Monteiro and Assunção (2012), Bruhn (2011, 2013) and Kaplan, *et al.*, (2011).

4 The International Finance Corporation (2013; 46) suggest that “business entry reforms work best when complemented with other investment climate reforms”.

one single tax payment. Zinnes (2009) describes how the implementation of a simple non-discretionary tax that can be collected cheaply and with high compliance can lead to better working conditions for the poor. Increasing the threshold for payment of Value Addition Tax has also greatly reduce the bureaucratic burden for MSEs and start-up businesses and contribute to greater activity in the formal business sector (ILO 2015).

The evidence finds that reforms to streamline and improve tax administration do indeed contribute to the formalisation of informal firms.⁵ The International Finance Corporation (IFC 2013) claims 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.

Labour and labour-related issues

MSEs tend to compensate their low productivity with informal employment arrangements. In the process they can save 25 to 45 per cent of the gross payroll. In 2012, in Latin America and the Caribbean, for example, 60 per cent of workers in micro-enterprises were considered informal because they were not covered by health insurance (ILO 2014a). In addition, attention has been drawn to the impacts of labour laws on informality and the ILC (2007) indicates that “well-designed labour legislation and policies are important to the development of sustainable enterprises”. Reforms to the labour law include minimum wage

and employment protection legislation.⁶ The challenge here is to find the balance between increasing the level of protection for formal workers, while encouraging informal MSEs to adopt more formal employment practices. 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. What is needed is the re-regulation of labour markets to protect informal workers from the economic risks and uncertainty associated with these trends. The DCED (2011) says the “*challenge of balancing enterprise growth and workers’ protection calls for an active role of the state, particularly in implementing a legal framework for the labour market, basic social protection (e.g., health and safety, minimum income), and skills development*”.

There are a number of approaches that can be taken to expand social protection coverage in MSEs. These include 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

5 See Rand and Torm (2012), Boly (2015), Fajnzylber, *et.al.*, (2009), Kenyon and Kapaz (2005) and McKenzie and Sakho (2010).

6 The IFC (2013) *Jobs Study* and the World Bank (2013) *World Development Report 2013: Jobs*, including the background paper to this report provide information that synthesises existing research and covers a wide range of labour-related reforms. Berg and Kucera (2008) provide an important overview on the work of the ILO.

schemes are those with simply, affordable contribution rates that are integrated into one single payment or with a payment schedule that can be adapted. A key factor here is the quality of the services provided by social security schemes. The quality of the benefits in the areas of health, maternity and unemployment determine whether or not the systems respond to the needs of their (potential) affiliates. People's confidence in their pension systems, generated through clear and respected rules, transparent criteria and stable indexing systems, are equally important. Adequate insurance coverage for accidents at work and occupational diseases in MSEs also acts as an incentive to labour formalisation.

Land ownership and titling

The lack of access to land title has been considered a key challenge facing informal MSEs and there have been many studies that present the relationship between improved property rights, economic growth and poverty reduction.⁷ This issue is particularly acute when the lack of access women have to formal property rights is considered.⁸ To this end, policy reforms that promote formalisation have often included land titling and administration reform. Thus, reforms have focused on redressing incomplete

cadastres, onerous or costly land registration procedures, and addressing intrusive government ownership of land. In some cases, land ownership and titling reforms have been introduced to increase the capacity of poor women and men to raise capital through land-based collateral. However, the impact of these initiatives has not proved to be sufficient, again reflecting the multifaceted nature of informality and its causes.⁹ Formal land title is only one factor affecting access to credit.

Finally, Palmade and Anayiotos (2005) recommends that governments relax tenant laws, zoning restrictions, and building codes to provide a relatively quick and easy way to increase the availability of formal land. In addition, land property taxes should be increased to discourage speculators from holding vacant land and to provide local governments with the financial means and incentive to develop more land for commercial and residential use.

Judicial reform

Informal enterprises do not typically have access to the formal commercial court system. This requires them, says Zinnes (2009) "to restrict their transactions to the immediate locale and to be with those parties with whom they have personal or

7 The concept of 'property rights' is broad and includes "the rights individuals appropriate over their own labour and the goods and services they possess" (North 1990). Authors such as De Soto (2000) have long argued that household property rights and formal land titles have a significant impact on capital formation and poverty. Acemoglu, *et.al.*, (2001) have shown the importance of property rights and good institutions, while Acemoglu and Johnson (2005) find that good 'property rights institutions' have a "first-order effect on long-run economic growth, investment, and financial development".

8 See World bank (2014).

9 Bromley (2009) critiques these claims and provides a secondary analysis of the literature to argue that the focus on formalisation is misplaced: poor people are not poor because they don't own the land, but because of a broader set of "flawed economic policies". He argues there is very little empirical evidence linking the formalisation of land titles to poverty reduction and that land tenure reform should not be elevated above other policy reform priorities. This view is supported by Payne, *et.al.*, (2009) and Cousins *et.al.*, (2005).

social ties". While these arrangement allows the parties to make use of informal dispute resolution processes and traditional means of justice, they can be locked out of formal dispute resolution mechanism and the commercial courts. 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 (DCED 2011). In addition, the Commission on Legal Empowerment of the Poor (2008) recommends the improvement of identify registration systems (without user fees) and the strengthening of legal aid systems with expanded legal service specialists.

Financial services

The ILO (2015a) 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. Although informal finance mechanisms and microfinance institutions have received support to help informal enterprises gain access to finance, the process of formalisation involves reforms that increase the access of poor women and men to the full range of financial services.

Kanji (2015) recommends that policy incentives be introduced to encourage financial institutions to develop profitable initiatives that promote the formalisation of their informal clients. This includes the use of formal bank accounts to ensure informal enterprises and their workers are a part of the formal banking system.

Intellectual property rights

The World Intellectual Property Organization (2005) has highlighted 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.¹⁰ On a broader scale, poor intellectual property policy can lead to informal provision of substandard products. Informal enterprises sometime use trademarks and other property illegally and campaigns are needed to replace illegal products with legally protected products. These initiatives should aim to provide economic opportunities for operators based on consumer benefits and protection under legal operation.

¹⁰ One example illustrating the use of intellectual property rights relates to traditional medicines in the People's Republic of China, in respect of which several thousand patents have been granted in past years (World Intellectual Property Organization 2005).

3. Best Practices in Policy Reform

This section outlines the practices and approaches toward policy reform in the informal economy.

Develop an integrated, holistic response

The ILC (2015) recommends its Members adopt an integrated policy framework to facilitate the transition to the formal economy that is “included in national development strategies or plans as well as in poverty reduction strategies and budgets, taking into account, where appropriate, the role of different levels of government”. This framework should address all aspects of the drivers of informality, including the establishment of an appropriate legislative and regulatory framework, respect for and promotion and realisation of the fundamental principles and rights at work, the organisation and representation of employers and workers to promote social dialogue, the promotion of equality and the elimination of all forms of discrimination and violence, including gender-based violence, the promotion of entrepreneurship, as well as access to education, lifelong learning and skills development, financial and business services, markets, infrastructure and technology, and the extension of social security coverage. The DCED (2011) also recommended that while it is “tempting to dive into specific reforms targeting the informal economy, it is often better to consider the big picture first and to understand the broader relationship that exists between formal rules and institutions and informal economic

actors”.¹¹ This suggests that reformers should carefully assess the political economy of reform in the country and identify the drivers of, and resistance to, change.¹² Understanding the business environment system and how a change to one part of the system will affect it elsewhere is essential. This also calls for coherence and coordination across all reform initiatives.

Recognise gender disparities

In most countries around the world, there are more women than men employed in the informal economy, with the exception of Latin America and the Caribbean (ILO 2013). Indeed, there are many gender related issues that affect the nature and size of the informal economy — many women are excluded from full participation in the formal economy on the basis of their sex. Thus, the Commission on Legal Empowerment of the Poor (2008), among many others, recommend that reformers ensure that legal empowerment drives gender equality. The promotion of the International Labour Standards, for example, should actively promote the elimination of discrimination and equality of opportunity for, and treatment of, women. This issue affects all areas of reform practice, from the collection and analysis of data, to the identification of reform priorities, the design of reform program, and the engagement of women in dialogue around all these processes.

11 Chen (2007) argues that it is important to distinguish between the formal and informal economies even though “in real life” it is often hard to know what is driving what: as large formal registered enterprises are often involved in ‘setting’ formal policies and regulations; and formal policies and regulations are often biased towards formal registered firms to the disadvantage of both informal enterprises and informal wage workers.

12 Also see Legal Assistance for Economic Reform (2015).

Work with non-traditional representative organisations

One of the defining features of informal MSEs is their lack of formal representation. Most informal enterprises are not involved in representative organisations, such as the chamber of commerce or national Employer's Organisation. Thus, to address this, policy reformers need to extend their reach beyond the traditional business and employer structures and to connect with informal business membership organisations, Workers' Organisations and other informal enterprise and worker coalitions. In some cases, reformers should use the media and community organisations to reach out to the informal business community, recognising that low levels of literacy poor Internet access can hamper such efforts.

Broadening dialogue for reform

Public-private and social dialogue is an important mechanism for designing and monitoring policy reforms. However, formal actors often dominate this dialogue. Thus, reformers need to find ways in which these dialogue mechanisms can be expanded to involve a broader set of actors, including local community and informal enterprise representatives. All partners must establish a broad-based consensus on the priorities for reform based on empirical evidence, a common understanding of real impacts and risks, and a thorough knowledge of local contexts and environments.

Understand the motivations for formalisation

Many informal MSEs are not interested in formalising their enterprise. They may not enjoy their current informal status, but neither do they aspire to become formal. For some this may be because the enterprise is simply considered a stopgap between jobs, for others this may be because they lack the interest in growing their business. It is important that reformers respond to the ambitions and motivations of informal actors and, where possible, offer affordable choices that lead toward formality. Reformers should highlight the anticipated and actual benefits of reform so that all actors recognise how this will improve the circumstances of all private enterprises, especially informal enterprises.¹³ This will also require a good communication strategy, discussed below. Finally, it is also important to sensitise all other relevant stakeholders and raising their awareness of the need for and benefits of reform. For example, government should be encouraged to realise that formalisation is not only about increased tax revenue, but also about the need for better government services.

13 Chen (2007) recommends that reformers take into account the benefits due to informal enterprises if they operate formally and to wage workers if they get a formal job; and the costs of working informally for the self-employed and the wage employed. The policy challenge is to decrease the costs of working informally and to increase the benefits of working formally.

Balance incentives with better enforcement

Policy reforms that promote the formalisation of reforms can create incentives for MSEs to become more formalised. Incentives may include better access to public procurement opportunities, commercial finance services or social protection schemes. These approaches highlight the benefits of becoming formal. Van Elk and de Kok (2014) also recommend the use of innovative tools to increase formalisation, such as a lottery with free tickets for those having paid taxes. However, these efforts should also be balanced by reforms that improve enforcement. Drawing from reform experiences in Brazil, Kenya and Kapaz (2005) suggest that reformers “keep hold of the stick”. Tackling informality requires governments pay more attention to enforcement and introduce stiffer penalties for noncompliance. De Giorgi *et.al.*, (2015) also provide evidence of the impact of “credible threats” as disincentives for informality.

Increase engagement with the corporate sector

Increasing attention is being given to the role of the corporate sector, including multinational enterprises (MNEs). These firms are able to create new commercial opportunities for informal enterprise to formalise and pursue. Development agencies and governments can work with MNEs and other lead firms to analyse strategic value chains and identify new commercial opportunities.¹⁴ Jenkins (2015) argues that governments and their social partners must recognise that MNEs have a key role to play: “*Business value and development impact can be mutually reinforcing*”.

Communicate reforms

It is essential to ensure that reform initiatives are communicated to all concerned, including the end-users (i.e., informal enterprises). This may include information campaigns, the use of print and electronic media, making relevant information available online, and outreach to remote locations to help firms understand and comply with their obligations. Formalisation should introduce the benefits of compliance with the legal and regulatory framework. MSEs should see formalisation as an opportunity for greater access to markets and growth.

14 For examples see ILO (2015b) and Jenkins (2015).

Complement policy reforms with support services

Policy for formalisation should include services that help informal MSEs improve their capacity to operate competitively in the formal economy. The DCED (2011) argues that business environment reform is, on its own, not enough. Many of the drivers of informality are beyond the reach of reform interventions and consideration should be given to financial and business development services. These include access to resources that boost enterprise productivity and growth, education and health services, housing and infrastructure, while reducing corruption and creating social safety nets. There may also be a need for services that help firms understand and tackle the steps required to comply with the relevant laws and regulations and remain compliant.

Pay attention to implementation

Many policy reformers do not pay sufficient attention to the challenge of implementation. While a new policy, law or regulatory procedure may be introduced, it is of little use if it is not effectively implemented or enforced. This involves addressing the issues of institutional change and capacity building. Van Elk and de Kok (2014) highlight the need for policy to be implemented correctly and run by competent staff, suggesting that government officials should *“change their arrogant behaviour towards those in the informal sector”*.

Invest in more evidence and better monitoring

There is a need for more information about the informal economy. This includes statistical data that measures its size and character as well as information on the impact of formalisation policies and programs. Chen (2007) posits that compiling statistics on the size, composition and contribution of the informal economy is hampered by the lack of sufficient data. While the ILO (2013) has been addressing this, only a handful of countries are collecting comprehensive data on informality in enterprises and among workers. Van Elk and de Kok (2014) claim there is a lack of data and evaluation findings that provide good practice examples. Reforms need to be carefully monitored over a considerable length of time to monitor and evaluate success and determine good practices. Finally, the ILC (2015b) concludes that *“the ILO should build more robust knowledge on approaches that promote SME formalisation and compliance with labour and social legislation”*.

4. Conclusions and Key Lessons

This Brief outlined a range of policy reforms and practices that can be used to promote the formalisation of the informal economy. It has highlighted the importance of understanding the multiple causes of informality and warned against taking a single, one-size-fits-all approach to formalisation. The size and character of the informal economy is the result of a confluence of economic, social and political forces that is unique to each country. While there may be common trends and challenges that countries share, the response requires a careful diagnosis of all these forces. Similarly, there are a number of policy domains that can affect the decision of MSE owners and managers to remain informal or to make the transition toward a more formal status.

The DCED (2008; 18) presents four phases of business environment reform: diagnosis, solution design, implementation, and evaluation and sustainability. Within each of these there are specific practices that reformers and program managers employ to achieve success. Applying these phases, a series of key lessons can be distilled from the policy approaches and practices presented in the previous sections.

Key lessons in diagnosis:

- While there are common drivers to informality, the combination of economic, social and political forces will vary from region to region and country to country;
- Diagnosis of the informal economy and the prospects for reform should include a political-economic analysis in which reform drivers, opponents, winners, and losers can be identified;
- The lack of regular and comprehensive, gender-disaggregated, statistical data on the informal economy may require additional studies and consultations that help reformers better understand the nature and dynamics of the informal economy;
- It is important to understand the motivations enterprises owners and managers have for remaining informal;
- It is important to understand the range of systems that shape informality;

- Government attitudes toward the informal economy and unregistered and unlicensed enterprises is important;
- The gender dimensions to the informal economy should be carefully assessed;
- The impact of informality on indigenous groups needs to be assessed;
- Publish the results of your diagnosis and encourage debate on the findings;
- Defining an agenda for reform requires consultation and dialogue that goes beyond formal business, Employers' and Workers' Organisations to include various formations in which informal enterprises and workers are engaged.

Key lessons in solution design:

- It is important to apply a systemic response to formalising the informal economy, recognising that change in one part of the system, can affect other parts of the system (e.g., the formal and informal economies are closely linked);
- Formalisation policies and programs should be linked to broader economic, social and environmental policies and strategies;
- A single solution is unlikely to be enough — policy reforms require a multi-faceted and integrated response to the needs, challenges and opportunities facing informal actors;
- Formalisation policies and programs should be directly linked to the overall objective of creating full and productive employment and decent work for all;
- While the formalisation of informal enterprises and their workers is the goal, it may also be important to respond to the immediate threats and vulnerabilities (e.g., improving access to social protection);
- Specific formalisation policies and programs should be designed for informal businesswomen;
- It is important to ensure formalisation policies and programs respond to market conditions and increase the access MSEs have to new market opportunities;
- Consider expanding the range of incentives for formalisation, while strengthening transparent, rule-based enforcement mechanisms and penalties for non-compliance;
- Holistic approaches are needed and consideration should be given to programs that complement policy reforms and help new and growing enterprises take advantage of the opportunities created by a better business environment;
- Policies and programs affecting the informal economy should be integrated into broader business environment reform programs, ensuring that

improvements in the legal and regulatory regime and the institutional framework enhance the opportunities for formalisation;

- Wherever possible, formalisation policies and programs should be connected to the formal economy and to helping MSEs participate more effectively in strategic national and global value chains — this should be done in partnership with MNEs and other lead firms;
- Explore the opportunities for public-private partnerships.

Key lessons in implementation:

- Attention must be given to promoting policy coordination and coherence across a range of government ministries, departments and agencies, as well as from national to local levels of government;
- Government capacities for effective implementation should be addressed, ensuring that public officials at all levels understand the rationale for, and the implications of, reform;
- Formalisation policies and programs should be well communicated — to all the relevant stakeholders (who need to know about the reforms and programs and what they seek to achieve), as well as to the ultimate beneficiaries (i.e., informal MSEs and their workers);
- Adopt a flexible approach to policy and program implementation — monitor progress, take a practical and strategic approach to problem solving, learn from experience (trial and error) and adjust accordingly.

Key lessons in evaluation and sustainability:

- A sound, gender-sensitive, monitoring and evaluation system is required for all formalisation policies and programs, providing regular feedback mechanisms and measuring impact;
- Knowledge management is essential to learn from the experiences and results of formalisation policies and programs and to identify and promote good practices;
- Regular and expanded social dialogue — involving Government, Employers' and Workers' Organizations, as well as informal business organisations and other social formations, including women's and indigenous organisations — should be sustained.

Reference List

- Acemoglu, D. and S. Johnson (2005) “Unbundling institutions”, *Journal of Political Economy*, 113(5), pp. 949–995.
- Acemoglu, D., Johnson, S. and Robinson, J.A. (2001) “The colonial origins of comparative development: an empirical investigation”, *American Economic Review*, 91(5), pp. 1369–1401.
- Berg, J. and D. Kucera (eds) (2008) *In defence of labour market institutions: Cultivating justice in the developing world*, ILO, Geneva
- Boly (2015) On the Effects of Formalisation on Taxes and Wages: Panel Evidence from Vietnam, UN WIDER Paper 2015/042
- Bruhn, M. (2013) “A Tale of Two Species: Revisiting the Effect of Registration Reform on Informal Business Owners in Mexico” *Journal of Development Economics* 103: 275-83
- Bruhn, M. (2011) “License to Sell: The Effect of Business Registration Reform on Entrepreneurial Activity in Mexico”, *Review of Economics and Statistics*, 93(1) pp. 382–386.
- Chen, M.A. (2007) *Rethinking the Informal Economy: Linkages with the Formal Economy and the Formal Regulatory Environment*, DESA Working Paper No. 46, July, ILO, Geneva
- Commission on Legal Empowerment of the Poor (2008) *Making the Law Work for Everyone*, Vol. I, Report of the Commission on Legal Empowerment of the Poor, UNDP, New York
- De Giorgi, G., M. Ploenzke and A. Rahman (2015) *Small Firms’ Formalization The Stick Treatment*, Policy Research Working Paper 7318, World Bank, Washington DC
- De Soto, H. (2000) *The Mystery of Capital: Why Capitalism Thrives in the West and Fails Everywhere Else*, Basic Books, New York
- Donor Committee for Enterprise Development (2011) *Supporting Business Environment Reforms; Practical Guidance for Development Agencies; Annex: How Business Environment Reform Can Promote Formalization*, DCED, Cambridge
- (2008) *Supporting Business Environment Reforms: Practical Guidance for Development Agencies*, Cambridge
- Elk, K. van and J. de Kok (2014) *Enterprise formalization: Fact or fiction? A quest for case studies*, GIZ Eschborn and ILO Geneva
- Fajnzylber, M., and Montes-Rojas (2011) “Does formality improve micro-firm performance? Evidence from the Brazilian SIMPLES program”, *Journal of Development Economics*, Vol. 94, pp. 262-276.
- Fajnzylber, P., W. Maloney and G. Montes Rojas (2009) “Releasing constraints to growth or pushing on a string? Policies and performance of Mexican micro-firms” *Journal of Development Studies* (45) pp. 1027–1047.
- International Finance Corporation (2013) *The Jobs Study: Assessing Private Sector Contributions to Job Creation and Poverty Reduction*, World Bank Group, Washington DC
- International Labour Conference (2015a) *Recommendation No. 204 Concerning the Transition from the Informal to the Formal Economy*, Recommendation adopted by the Conference at its 104th Session in Geneva, on 12 June 2015

- (2015b) *Resolution Concerning Small and Medium-Sized Enterprises and Decent and Productive Employment Creation*, adopted by the Conference at its 104th Session in Geneva, on 12 June 2015
- (2007) *Conclusions concerning the promotion of sustainable enterprises*, International Labour Conference, June
- (2002) *Conclusions Concerning Decent Work and the Informal Economy*, adopted by the International Labour Conference at its 90th Session (2002)
- International Labour Organization (2015a) *Formalizing enterprises in Mongolia: Challenges and policy directions*, ILO Decent Work Team for East and South-East Asia and the Pacific, Ulaanbaatar
- (2015b) *Formalisation of small and medium enterprises in supply chains in Latin America: what role for multinational enterprises? Issue Brief*, ILO Programme for the Promotion of the Formalization in Latin America and the Caribbean, ILO Regional Office for Latin America and the Caribbean
- (2015c) *Small and Medium-Sized Enterprises and Decent and Productive Employment Creation*, Report to the International Labour Conference, 104th Session, 2015, ILO Geneva
- (2014a) *Policies for the formalization of micro and small enterprises*, ILO Programme for the Promotion of the Formalization in Latin America and the Caribbean, ILO Regional Office for Latin America and the Caribbean
- (2014b) *Policies for the formalization of micro and small enterprises in Brazil*, ILO Programme for the Promotion of the Formalization in Latin America and the Caribbean, ILO Regional Office for Latin America and the Caribbean
- (2014c) *Policies for the formalization of micro and small enterprises in Chile*, ILO Programme for the Promotion of the Formalization in Latin America and the Caribbean, ILO Regional Office for Latin America and the Caribbean
- (2014d) *Policies for the formalization of micro and small enterprises in Colombia*, ILO Programme for the Promotion of the Formalization in Latin America and the Caribbean, ILO Regional Office for Latin America and the Caribbean
- (2014e) *Policies for the formalization of micro and small enterprises in Costa Rica*, ILO Programme for the Promotion of the Formalization in Latin America and the Caribbean, ILO Regional Office for Latin America and the Caribbean
- (2014f) *Transitioning from the informal to the formal economy*, Report V (1), International Labour Conference 103rd Session, Geneva
- (2013a) *Report of the Conference, Seventeenth International Conference of Labour Statisticians*, International Labour Office, Geneva, 24 November-3 December 2003
- (2013b) *Women and men in the informal economy: A statistical picture (Second Edition)*, ILO Geneva
- (1991) *The dilemma of the informal sector*, Report of the Director-General, International Labour Conference, 78th Session, Geneva
- (1972) *Employment, incomes and equality: A strategy for increasing productive employment in Kenya*, ILO, Geneva
- Kanji, I. A. (2015) *Role of Finance in Driving Formalization of Informal Enterprises*, ILO, Geneva
- Kaplan, D.S., E. Piedra and E. Seira 2011 “Entry regulation and business start-ups: Evidence from Mexico, *Journal of Public Economics* (95) pp. 1501–1515

- Legal Assistance for Economic Reform (2015) *Doing Investment climate Reform Differently. Why, What and How?* Department for International Development, London
- Jenkins, B. (2015) *Empowering Small Businesses in Corporate Value Chains: The Case of SABMiller's 4e Camino al Progreso Program*; Harvard Kennedy School and Business Fights Poverty, Harvard, Boston
- Kenyon, T. and E. Kapaz 2005 *The Informality Trap*, Viewpoint Series, Note 301. World Bank Group, Private Sector Development Vice-Presidency, Washington, DC
- Kenyon, T. and E. Kapaz (2005) *The Informality Trap; Tax Evasion, Finance and Productivity in Brazil*, Public Policy for the Private Sector, Note Number 301, December, World Bank Group, Washington DC
- McKenzie, D., and Y.S. Sakhoa 2010 "Does it pay firms to register for taxes? The impact of formality on firm profitability", *Journal of Development Economics* (91) 1, January, pp. 15–24
- Monteiro, J.C.M. and J.J. Assunção (2012) "Coming out of the shadows? Estimating the impact of bureaucracy simplification and tax cut on formality in Brazilian microenterprise", *Journal of Development Economics*, (99) 1, September, pp. 105–115
- Neuwirth, R. (2011) *Stealth of Nations; The Global Rise of the Informal Economy*, Pantheon Books, New York
- North, D. 1990, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, Cambridge
- Palmade, V. and A. Anayiotos (2005) *Rising Informality; Reversing the Tide*, Public Policy for the Private Sector, Note Number 298, December, World Bank Group, Washington DC
- Rand, J., & Torm, N. (2012) The benefits of formalization: Evidence from Vietnamese manufacturing SMEs, *World Development* (40) pp. 983–998
- Warner, A. M. (2012) *Impact Evaluation of Business License Simplification in Peru: An Independent Assessment of an International Finance Corporation-Supported Project*, IFC, October, Report No. 74469
- World Bank (2013) *World Development Report 2013: Jobs*, World Bank Group, Washington DC
- World Intellectual Property Organization (2005) *Intellectual Property and Traditional Knowledge*, Booklet No 2. Publication No. 920(E)
- Zinnes, C. (2009) *Business Environment Reforms and the Informal Economy; Discussion Paper*, Donor Committee for Enterprise Development, Cambridge



