



Enterprise Formalization

WHAT DOES FORMALIZATION MEAN FOR ENTERPRISES?

Enterprise formalization refers to a process that firms go through when formalizing their business.

It has various dimensions:

- *Registration and licensing with the national, provincial and municipal authorities;*
- *Access to social security for the business owner and his/her employees;*
- *Compliance with the legal framework, including tax, social security and labour laws.*

Formalization takes place in stages. An entrepreneur may for example have a municipal operating licence to run the business at its location, whilst not having registered with the tax, labour and social security offices.

HEADLINE FACTS AND FIGURES*

2 billion	people are in informal employment
8 out of 10	economic units are informal
36 percent	share of self-employed among women in informal employment
47.2 percent	of global employment was provided by informal sector economic units in 2019

*Figures have been updated with data from 2019-21.

WHY DOES THE ILO PROMOTE ENTERPRISE FORMALIZATION?

The ultimate goal of enterprise formalization initiatives is to create more and better jobs, reduce poverty and address marginalisation of 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 and persons with disabilities.

For governments and society, the formalization of micro, small and medium-sized enterprises goes hand in hand with a conducive business environment, economic growth and better working conditions. It also increases tax revenues which in turn are needed to provide public goods and services. Formal businesses benefit from enterprise formalization in the sense that it reduces unfair competition by informal firms. Formalizing enterprises gain access to finance, business development services and technologies and reduce their exposure to government fines. They can also participate in public biddings or act as suppliers or retailers of larger companies.

Formalization of enterprises is part of a multidimensional and balanced approach, as outlined in ILO Recommendation 204 concerning the Transition from the Informal to the Formal Economy. It is also essential for the formalization of employment in these enterprises. As such it contributes to the Sustainable Development Goals (target 8.3 on decent job creation and the formalization and growth of MSMEs).

January 2017



EASE business,
create jobs

Enabling Environment for Sustainable Enterprises

INTERVENTION MODEL

Simplified business registration, improved access to finance, markets, business knowledge and social security

DIRECT OUTCOMES

Improved business practices and productivity, increased income and social security coverage

INTERMEDIATE OUTCOMES

More and better jobs, reduced vulnerability, social cohesion

FINAL OUTCOMES

HOW DOES THE ILO FACILITATE ENTERPRISE FORMALIZATION?

Enterprise formalization initiatives combine measures to reduce registration and compliance costs with incentives and business development initiatives. Based on the most recent empirical evidence on what works to formalize enterprises, the ILO designs initiatives on the premise that it is probably not so much the expected costs but rather the benefits of formalization that is pivotal for the decision to formalize, and that entrepreneurs compare the costs with the benefits of running a formal business. If the benefits outweigh the costs, they may consider to formalize the business (see also Figure 1).

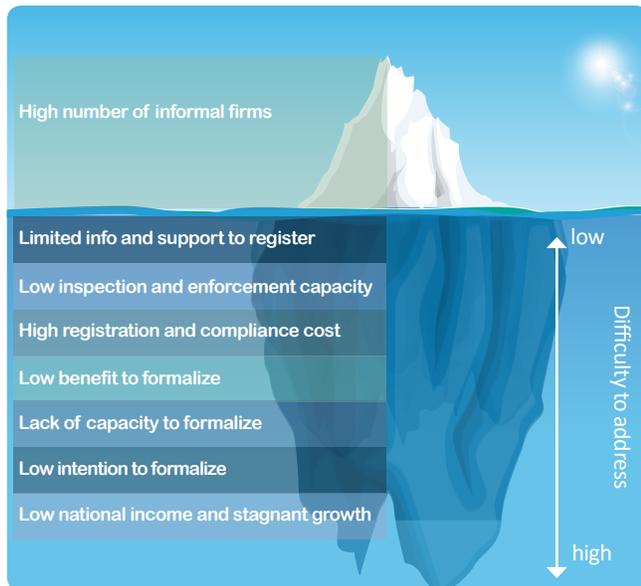
Interventions may be geared towards specific sectors, geographical areas or sub-groups of enterprises (e.g. start-ups vs. existing firms).

Enterprise formalization measures aim to:

- **Reduce entry barriers** through streamlined business registration, licensing and compliance;
- **Incentivize formalization** through market access, increased social security coverage and reduced taxes or other financial obligations;
- **Enhance business productivity** through business upgrading, technical skills training and access to finance and business development services;
- **Facilitate dialogue** by supporting employers' organizations to develop relevant services and by supporting the involvement of informal business associations and representative bodies through advocacy;
- **Strengthen enforcement and compliance** through preventive and corrective measures.

As outlined in Recommendation 204, enterprise formalization is part of a wider approach concerning the transition from the informal to the formal economy, which includes measures to strengthen economic, social and environmental policies, build sound institutions and enhance fair competition in national and international markets.

FIGURE 1: ENTERPRISE INFORMALITY



WHAT IS THE PROCESS FOR SUPPORT FROM THE ILO?

- 1. Sensitization:** Support from the ILO begins with sharing information on guiding principles, an intervention logic and good practices and lessons learnt on enterprise formalization.
- 2. National diagnosis:** In response to an expressed demand from constituents, *assessments* are done to gather information on informal enterprises and the environment in which they operate. An assessment will take place to estimate the extent of informal enterprises and informal employment in these enterprises, to identify the characteristics of *informal enterprises*, to find out the main drivers that shape informality. Drivers may be specific to enterprises (e.g. low capacity to formalize) or may relate to the environment (e.g. legal framework). Assessments are based on primary data collection through enterprise surveys as well as on secondary research concerning the *legal, policy, regulatory and*

institutional environment. More information on these assessments is provided on page 7. Alternatively, a wider initiative may be launched on the creation of an enabling environment for sustainable enterprises (ESEE) which also puts a special focus on enterprise formalization.

- 3. Dialogue** with constituents will take place as part of the assessments and to agree on prioritized actions or building blocks for reform and support to formalizing entrepreneurs. The action plan will be based on the government's willingness to put in place business environment reforms, incentives and business development measures.
- 4. Development and implementation of policies and other measures:** Once priorities are defined by stakeholders, additional support from the ILO includes the identification, design and implementation of enterprise formalization *initiatives* (see building blocks on page 4). Specific priority sectors or regions may be identified to launch such interventions.
- 5. Monitoring and evaluation** assistance is provided through the design of a gender-sensitive monitoring and evaluation system and wherever feasible, experimental impact assessments.

Building Blocks to Foster Enterprise Formalization

A multidimensional enterprise formalization initiative combines legal, regulatory and policy reforms with support programmes and incentives. Interventions are designed based on the *building blocks* as outlined below. As the dynamics differ per region and per segment of entrepreneurs, interventions will combine those building blocks that are relevant and tailored to the stage of formalization and geographical context.



A

SENSITIZATION AND CAPACITY DEVELOPMENT

Familiarize constituents and other stakeholders with concepts and good practices on enterprise formalization by providing an overview of Recommendation 204 (with respect to enterprise formalization) and share the intervention logic and guiding principles for an enterprise formalization strategy.



B

STREAMLINE BUSINESS REGISTRATION, LICENSING AND COMPLIANCE

Simplify business registration and licensing

- Provide information and support to register and licence a business at the central and local level (e.g. revise regulations and by-laws, create a one-stop shop for registration support);
- Streamline and simplify the registration and licensing process (e.g. reduce the number of steps to register a small business, introduce electronic registration);
- Put in place a simplified legal format and licensing requirements for MSEs;
- Enhance administrative coordination.

Simplify compliance

- Simplify procedures for licence renewals and export requirements and improve access to information (e.g. one-stop shop and administrative coordination);
- Simplify tax and social security payments (e.g. presumptive tax measures or a '*monotax*' system to merge various taxes and social security contributions into one lump sum amount for MSEs);
- Simplify reporting and accounting requirements.



INCENTIVIZE FORMALIZATION

Simplify business registration and operation

- Reduce business registration fees;
- Provide financial incentives to MSEs, such as (temporary) tax breaks or simplified tax and social security contributions linked to business size.

Increase social security coverage

- Increase the social security coverage for entrepreneurs, their families and their employees (e.g. health protection, pensions, employment injury or disability benefits).

Facilitate market access

- Improve access to public procurement opportunities for formal MSEs (e.g. through simplified procedures, smaller lots, quotas, payment deadlines, capacity building for government officials and involvement of formal MSEs in public works);
- Increase access to procurement by large local and multinational enterprises (e.g. through fostering linkages between corporates and MSEs, setting targets for sub-contracting under state contracts or through integrating MSEs in value chains).

ENHANCE BUSINESS PRODUCTIVITY

Business upgrading

- Provide market information, technical skills and business management training¹;
- Provide targeted business development services for MSEs;
- Launch measures to enhance innovation and technology transfers;
- Establish or strengthen a SME Development Agency for improved delivery and coordination of services;
- Create economies of scale through strengthening associations and cooperatives.

Financial inclusion

- Improve access to finance (e.g. female ownership of assets, credit line or guarantee fund for MSEs, collateral registry or mutual guarantee associations);
- Improve the relevance of financial services (e.g. develop leasing and insurance services, support access to finance and insurance through savings, credit and other forms of associations);
- Provide financial incentives (e.g. access to larger loans), training and registration support for small enterprises on the condition that they gradually meet formalization requirements;
- Link associations or semi-formal finance providers to the formal banking system;
- Launch financial education and awareness programme for MSEs.



¹ Business management training may include costing, marketing, record keeping, buying and stock control, productivity, business planning and working conditions.

FACILITATE DIALOGUE

Build on initiatives that strengthen associations and facilitate dialogue

- Strengthen public-private dialogue initiatives;
- Support employers' organisations in developing services to facilitate formalization of informal economic units and support the involvement of informal business associations and representative bodies of those who are especially vulnerable to the most serious decent work deficits in the informal economy through advocacy;
- Provide access to information and services (by also involving associations to operate as supporters, aggregators and negotiators for members that wish to register a business, access finance, insurance or social protection).



STRENGTHEN ENFORCEMENT AND COMPLIANCE

Preventive and corrective measures

- Develop compliance strategies for formalization addressing the main causes for non-compliance with registration obligations;
- Provide information and advice on how to comply with legislation through awareness raising, education and direct assistance to employers and workers;
- Enforce applicable rules through effective and deterrent sanctions;
- Strengthen capacities of labour inspection and other compliance mechanisms such as dispute resolution and the judiciary to engage on appropriate measures to address compliance gaps.

FOSTER LINKAGES FOR EXTERNAL SUPPORT

For some dimensions of enterprise formalization the ILO does not have the mandate to engage. Examples include reforms with respect to the judicial system, land ownership and titling and intellectual property rights. For such reforms, the ILO will assist constituents to identify suitable actors that can provide such support and create the required linkages.



RELEVANT TOOLS AND SUPPORT INTERVENTIONS

Sensitization and Capacity Development

Sensitization and Training Tools

Purpose: To sensitize constituents and other stakeholders on benefits, good practices, lessons learnt and intervention models for enterprise formalization (between 1 hour and 2 days)

Content: Training materials, distance learning and a webinar programme

Methodology: Sensitization events, classroom training, webinars, distance learning



Assessments

Informal Enterprise Survey Tools

Purpose: To take stock of the characteristics and dynamics of informal enterprises in the country, region or sector and gather information on their motivations, challenges and constraints to formalization and identify suitable incentives

Methodology: Secondary and primary research



Laws, Policies, Regulations and Institutions

Legal and Policy Review Tools

Purpose: To identify and review national, local or sectoral laws, policies, regulations, institutional arrangements and/or sectoral provisions applicable to MSMEs that affect formalization. Key elements include laws, policies, regulations and provisions related to: (i) Generic business registration and licensing (including a comparison of 'de facto' and 'de jure' situation); (ii) Specific business sectors; (iii) MSME sector (development); (iv) Government procurement; (v) Taxation; (vi) Social security and (vii) Labour law.

Methodology: Secondary and primary research



Tax Review Tools

Purpose: To identify tax regimes related to micro, small and medium-sized enterprises and assess entry points for reform or incentives for formalizing firms.

Content: Questionnaires and guidelines

Methodology: Secondary and primary research



Social Security Review Tools

Purpose: To identify possible measures to facilitate access to social security for micro, small and medium-sized enterprises and assess entry points for reform.

Content: Questionnaires and guidelines

Methodology: Secondary and primary research



Based on the information gathered, the ILO engages with constituents to identify entry points for reform and support.

KNOWLEDGE DEPOSITORY

The ILO holds a knowledge depository with information on enterprise formalization:

Generic information

- Overview of empirical evidence and good practices on enterprise formalization, [click here](#)
- Brief on policies, strategies and practices for the formalization of MSEs, [click here](#)

Small enterprise development

- Good practices and lessons learnt in the set-up of SME promotion agencies, [click here](#)

Market Access

- Overview of Good Procurement Practices and SMEs in Global Supply Chains, [click here](#)
- Policy brief on the role of SMEs in supply chains based on good practices in Latin America, [click here](#)

Women Entrepreneurship

- Policy Brief on how to enhance formalization among women entrepreneurs, [click here](#)

Financial Inclusion

- Policy Brief on the role of finance in driving formalization of informal enterprises, [click here](#)
- Guide for Employers Organizations to define a role in national microfinance strategies, [click here](#)
- Publication on how guarantee funds can foster SME lending, [click here](#)
- Publication on how to design and manage leasing schemes for SMEs, [click here](#)
- Training tools for financial service providers on how to manage product diversification, [click here](#)
- Training tools on financial education, [click here](#)
- Innovations in combining financial and non-financial services to foster formalization, [click here](#)

ADDITIONAL PRODUCTS AND EXPERTISE ON ENTERPRISE FORMALIZATION

In addition to the knowledge depository on enterprise formalization, the ILO can also build on the product lines as implemented by the SME Unit.

Below is an overview of these product lines, for which a wide range of tools are available (see weblinks for further information). Some of these tools are relevant for enterprise formalization initiatives, and can be adapted to the target group and/or the country context.

Product Lines	Products	What is it?
Building Entrepreneurship and Business Skills	<ul style="list-style-type: none"> • Entrepreneurship Education (Know About Business KAB) • Entrepreneurship Training (Start and Improve Your Business — SIYB) • Women’s Entrepreneurship Development (WED) 	<p>A training package to teach entrepreneurship in vocational, secondary, and tertiary schools, used in 56 countries of which 18 integrated KAB into national curricula, 2.3 million youth received KAB, see www.knowaboutbusiness.org</p> <p>A set of training packages for different groups ranging from a first orientation for potential start-ups to in-depth training for existing enterprises, offered in more than 100 countries with more than 6 million participants over the last ten years, see www.ilo.org/siyb</p> <p>Gender-sensitive training and support services empowering women to start and run their own businesses, offered in over 25 countries, see www.ilo.org/wed</p>
Providing Access to Markets	<ul style="list-style-type: none"> • Value Chain Development (VCD) 	<p>Interventions improving the functioning of entire markets or sectors that have the highest potential to create more and better jobs, one of our younger products facing an increasing demand (presently 20 active projects with a volume of USD 50 Mio), see www.ilo.org/valuechains</p> <p>Complemented by a knowledge generation project producing more evidence on the labour market outcomes of value chain interventions, see www.ilo.org/thelab</p>
Reforming the Enabling Environment	<ul style="list-style-type: none"> • Evidence Based Policy Development – Enabling Environment for Sustainable Enterprises (ESEE) 	<p>Advisory services on how to assess the environment in which businesses operate, as well as to formulate, implement, and monitor reform proposals, 15 country assessments in the last 2 years, see www.ilo.org/eese</p>
Improving Productivity and Working Conditions	<ul style="list-style-type: none"> • Training on Sustaining Competitive and Responsible Enterprises – SCORE 	<p>Training and in-factory counseling for medium sized companies producing for large international buyers, covering issues such as workplace cooperation, quality management, and occupational safety and health; rolled out in 8 emerging countries, see www.ilo.org/score</p>

WHAT DO WE KNOW?

- Enterprise formalization is mostly relevant for 'opportunity entrepreneurs'. Survivalist entrepreneurs often do not have the means, knowledge or ambition to formalize;
- Entrepreneurs make a rational choice on whether or not to formalize: they compare the expected costs of becoming and remaining formal with the benefits. When there is no 'business case' for formalization, many entrepreneurs prefer to operate below the radar screen;
- Reducing the compliance costs of being formal (taxes, social security and labour protection) might be more important than reducing the cost of becoming formal (time and money required to register);
- It is probably not so much the expected costs but rather the benefits of formalization that is pivotal for the decision to formalize;
- Business entry reforms can succeed in increasing the number of registered firms at a very good cost-benefit ratio in terms of additional income and employment creation;
- Simplifying business registration alone is not sufficient. It is also important that entrepreneurs increase productivity as this improves their income and thus their capacity to cover the costs associated with being formal;
- Interventions should include both 'carrots' (incentives) and 'sticks' (enforcement measures);
- It seems to be easier to formalize firms while they are being set up than to formalize firms that already exist;
- Big pushes and combining several reform measures may work better than piecemeal approaches. Single reforms have to aim for a large reduction of formalization costs in order to achieve any significant effect.

Where do I get more information?

ENTERPRISE FORMALIZATION is a product of the SME Unit of the ENTERPRISES department and is overseen by the Enabling Environment for Sustainable Enterprises (ESEE) Team. For further information please contact eese@ilo.org