

# ► Theory of Change: Enterprise formalization for decent work

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## ► I. Introduction

### Theory of Change with a focus on enterprise formalization

The Theory of Change (ToC) presented in this document is singling out only one measure, viz. enterprise formalization. It tries to describe the most plausible scenario how formalization can lead to more sustainable enterprises with decent work. It fits within the framework of the ToC on the transition from the informal to the formal economy.<sup>1</sup>

The ToC is based on the premises that i) informality jeopardizes enterprise survival and growth, hence reduces the likelihood of decent work; ii) although formalization is one of the key vehicles for attaining business stability and allowing growth, it needs to be considered along with other measures; iii) the registration and/or incorporation of all enterprises with the economic and legal national framework maximizes the chance of decent work for all, leaving no one behind, and iv) a shift towards greater formalization can benefit societies as a whole.

The strength of a ToC tends to be its simplicity and linear sequence. It creates a story line in which one thing leads arguably to another. To make the chain of events plausible, much of reality is reduced to its essential elements. Assumptions spell out the conditions of cause and effect relationships. In reality, however, a change process is much more complex, with side effects, loops and inverse relationships over time. A ToC is best used to predict how events may happen, given certain assumptions. It can be used to design an intervention model with specific inputs, outputs and outcomes aiming at achieving an overall objective.

### What do informality and enterprise formalization mean?

According to the Transition from the Informal to the Formal Economy Recommendation, 2015 (No. 204), the term “informal economy” refers to all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements. This does not cover illicit activities. Bringing activities from the informal to the formal economy means that they should be fully declared, covered by legislation and give rise to effective protection.

**Enterprise** formalization means bringing enterprises under the regulation with the advantages and obligations that this entails. It includes the extension of the scope of fiscal, labour and social security regulation to all enterprises without exception regarding the size, sector or other criteria, the legal recognition and registration of enterprises and compliance with legal requirements.<sup>2</sup> In order to measure informality among economic units, it is necessary to determine 1) to what extent economic units are **registered** with the relevant agencies at the national level, and 2) to what extent they **comply** with the regulations that apply to them (e.g. on business, tax, social, labour issues).

Against this background, it is important that formalization policies and strategies are tailored to the national context and the realities of different categories of target groups on the ground, enabling enterprises to transition to formality while ensuring the preservation and improvement of existing livelihoods during the transition.

1 ILO, [Transition from the informal to the formal economy - Theory of change](#), 2021.

2 ILO, [Transition from the informal to the formal economy - Theory of change](#), 2021. ILO, [Enterprise Formalization: An Introduction](#), Thematic Brief No. 1/2021.

When the **self-employed**<sup>3</sup> formalize their economic activity, both their economic unit and the entrepreneur are covered and protected by the laws that apply, while the economic unit can engage in formal business transactions.

Formalization of enterprises is for employees in the informal sector a pre-requisite for the formalization of their job. For employees and the self-employed, a transition to formality means providing them with adequate labour and social protection.

## What do enterprise formalization processes entail?

Enterprise formalization can be achieved by increasing the incidence of formality among economic units in a country. This implies (a) promoting the creation of formal economic units, (b) facilitating transitions of informal economic units to the formal economy and (c) preventing the informalization of formal economic units.

This includes putting in place a legal and regulatory framework along with non-regulatory interventions that reduce obstacles to formality and facilitate a transition to formality based on a process of social dialogue, such as (i) simplifying procedures and requirements, strengthening advantages to formalize and reducing the cost of operating in the formal economy; (ii) facilitating the registration of economic units and enhancing their capacity and willingness to comply with the law; (iii) increasing productivity of economic units, and (iv) making it less attractive to operate in the informal economy.

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.

## Drivers of informality

There are various drivers of informality among enterprises:<sup>4</sup>

► **Drivers at the enterprise level** (or obstacles to formalization) include the gender, age, education, entrepreneurial aspirations, and the degree of poverty of the entrepreneur, along with business productivity and the technical and management skills levels of entrepreneurs and workers. Survivalist entrepreneurs often do not have the means, knowledge or ambition to formalize. Women may face additional challenges which stand in the way of their formalization. Another driver relates to the size of the enterprise. The latter is often affected by adverse conditions in the business environment, such as limited access to finance.

Other drivers relate to the environment in which the enterprise operates, such as:

► **Drivers in the legal and institutional sphere** include rules, regulations and the governance of the economy, as well as the social assets and attitudes of people that engage in an economic activity to make a living (e.g. respect, autonomy, discrimination, cooperation). Weak laws, regulations, institutions and enforcement induce informality, which can be exacerbated by a lack of trust.

► **Drivers rooted in the economy** include macroeconomic characteristics of an economy, its ability to compete and its resilience to shocks. Fragile economies trigger informality, and vice-versa.

Recently, recognition has grown about environmental factors that generate or perpetuate informality. As many informal economic units depend on the availability and use of natural resources like minerals, forest, fish and farm land, limiting their access would restrain their livelihoods and very rationale of informal business. Environmental precariousness drives informality, and the other way round.

Realizing the reciprocity of causes and effects of informality, the ILO has developed an internationally agreed normative framework on the transition from the informal to the formal economy.<sup>5</sup>

3 In this document, the term "self-employed" refers to independent workers.

4 In this ToC, "enterprises" is used as an equivalent to "economic units", which is the expression that is included in the [Transition from the Informal to the Formal Economy Recommendation, 2015 \(No. 204\)](#).

5 See ILO Recommendation No. 204 (2015).

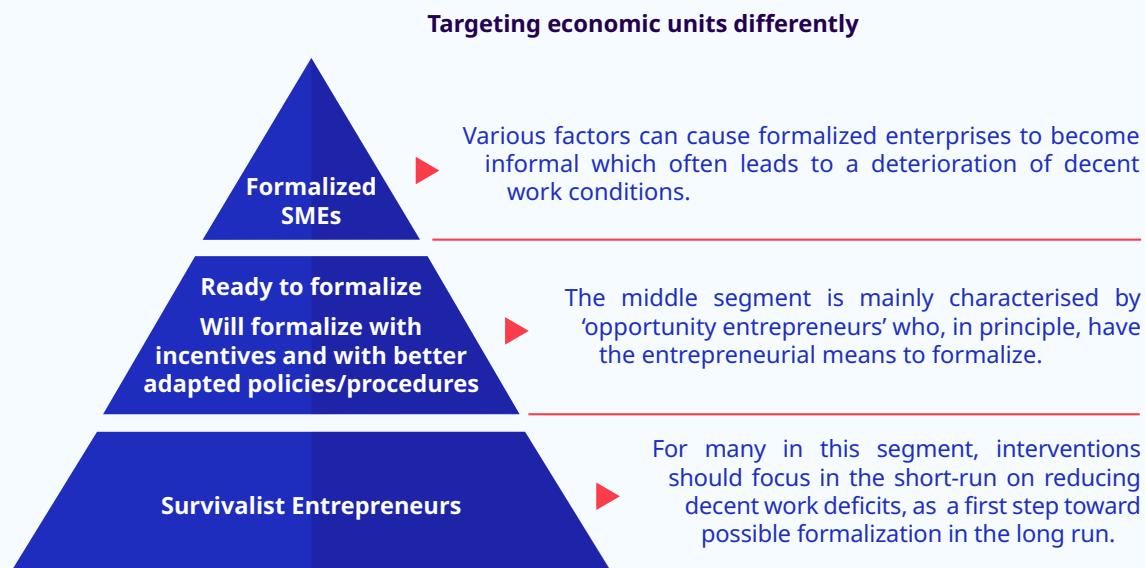
## Diversity among informal economic units

In many countries, informal enterprises make up the lion share of the private sector. But there are important differences among them, both in terms of the reasons for operating as an informal unit and the capacity – and willingness – to formalize. Three segments of enterprises can be distinguished which are represented in an “enterprise formalization pyramid” to reflect the size of each segment.

- ▶ At the bottom of pyramid are operators driven by necessity, for lack of any other source of labour income. For most, entrepreneurship is their last resort, with the main aim to stay afloat and survive.

- ▶ The middle group is referred to as “opportunity entrepreneurs”. In principle, they have the capacity to manage a business and the means to formalize it. Some have the potential to grow and create employment. Some of these enterprises are not yet able to formalize, whereas others comply with some, whilst deliberately not complying with other aspects of the law.
- ▶ At the top, usually the smallest group in developing and emerging countries, are the formalized enterprises, incorporated in the economic and legal system of a country.

Figure 1: Enterprise formalization pyramid



## Differentiation of approaches

Given the structural diversity and complexity of economies with many informal activities, strategies for the formalization of enterprises need to be gender-responsive and should be differentiated as well as to ensure that the approach is adapted to the context. There is simply no “one-size-fits-all”.

The Theory of Change (ToC) is trying to do justice to the segmentation and plurality of approaches. A more elaborate description of the issues and possible

solutions is presented in a series of Thematic Brief on Enterprise Formalization (ILO, 2021).<sup>6</sup>

Changes to enhance formalization can be realized with respect to the mentioned drivers of informality, depending on the national context and local circumstances of the economic unit. Interventions are more effective when they are combined and tackle different drivers of informality in an integrated approach.

<sup>6</sup> The Thematic Briefs on Enterprise Formalization are available here: [www.ilo.org/ef](http://www.ilo.org/ef).

## ► II. Theory of Change: Enterprise formalization for decent work

*Sustainable enterprises play an indispensable role for the creation of decent work ...*

Enterprises – of all types and sizes - are the main vehicle to create and sustain jobs and livelihoods and make economies grow.<sup>7</sup> In many countries, however, not all enterprises are fully integrated in, or covered by, the established, legal and regulatory system of a country. For a variety of reasons, only 2 out 10 economic units globally are registered as formal units.<sup>8</sup>

*... but wide-spread informality halts economic and social progress.*

Informal enterprises tend to miss out on market opportunities, their business owners and employees are usually not covered by social and labour protection and have no access to formal financial support, among others. The reduced ability to create business linkages, conclude legal contracts, obtain access to land and other productive resources, enhance productivity and enter into joint ventures is jeopardizing their survival and potential to grow. With increasing digitalization of societies, the lack of a registered legal status may prohibit an enterprise owner to access banking services.<sup>9</sup>

Importantly, high levels of informality among enterprises are associated with lower levels of decent work, too. For workers (including business owners), the consequences of informality can be significant. They impede the full exercise of rights and limit access to social security systems, notably social insurance. When workers operate under precarious circumstances it affects their full contribution to productivity and enterprise growth. Their skills and competences are not formally recognized by the education system.<sup>10</sup> Thus, economic informality leads to social exclusion.

A shift towards greater formalization can benefit society as a whole, through a more productive workforce, better regulated economic growth, increased rule of law, a more level playing field for fairer competition, a broader tax and contribution base that contributes towards the provision of public goods such as health care, education and social protection, and through enhanced social cohesion.

*Sustainable development remains elusive if people cannot all access opportunities for decent work ...*

Bringing all enterprises and workers within the same economic and social fabric of a country heightens its perspective on growth, improved welfare, social cohesion and equality. Formalization of enterprises and jobs enables people to work under conditions of decent work, which in turn spurs enterprise development through improved productivity and income growth. It also allows for expanding the purview of entrepreneurs to new and more market opportunities through investments, business linkages and access to services to boost innovation.

Increasingly, informality represents a threat to environmental sustainability too. The unsustainable use of natural resources such as, oceans, lakes, rivers, ground water, forests, arable land, minerals, building materials like stone and sand, etc. limits its availability for future generations. Moreover, the absence of sustainable practices on the disposal of waste materials, contamination, and air pollution harms human well-being and undermines the very continuation of the business itself. Yet informality is not a cause per-se for environmental degradation. Formal enterprises may also carry out unsustainable and harmful operations, due to ignorance, the absence or failure of environmental regulations and enforcement. Therefore, improving the legal and regulatory framework for enterprise formalization should go hand in hand with strengthening environmental governance for all enterprises.

*... making enterprise formalization a win-win proposition ...*

If effective incentives to formalize are in place, along with strong, effective institutions that are capable and willing to provide benefits for formalized enterprises, some enterprises will integrate in the formal economy and obtain benefits.<sup>11</sup> They can strengthen business linkages, while sealing and enforcing contracts with formal enterprises which helps them to expand their markets - including through exports. They may become eligible for public procurement tenders. Relevant and affordable finance as well as business development services will gradually become more accessible (as the main barrier of informality is removed), favouring

7 ILO, *Small matters - Global evidence on the contribution to employment by the self-employed, micro-enterprises and SMEs*, 2019.

8 ILO, *Women and men in the informal economy: a statistical picture*, 2018.

9 ILO, *Small goes digital - How digitalization can bring about productive growth for micro and small enterprises*, 2021.

10 Robert Palmer, *Lifelong learning in the informal economy: a literature review* (ILO, 2020).

11 ILO, *Product Offer - Enterprise Formalization*, 2017.

the adoption of technological innovation and productivity improvement, thereby increasing competitiveness. With the resulting higher profitability and greater job potential, a virtuous circle is created towards more decent work.

However, this dynamic may not hold for all informal units alike. When the self-employed engage in an economic activity with the principal aim to ensure subsistence, they may not all be able - or interested - to formalize and comply with all requirements in one go. Their economic capacity must be strengthened first, so that formalization may become affordable and feasible at a later stage. Viewed as a progressive process towards full formalization over time, enabling access to health and care services, social protection, urban infrastructure provisions, education and training, or Government support in times of shocks, such in the context of the COVID-19 pandemic, can facilitate transitions from the informal to the formal economy.

*... whilst Governments expand their tax base and raise revenues which may result in improved services.*

Tax revenues enable Governments to provide better public services that are essential for a conducive environment for enterprises. If governments have more fiscal space, they can also improve the conditions under which businesses operate, such as infrastructure (market places, transport, electricity, connectivity, waste management, security, etc.), investments in people (health, education, social protection) and fund capacity development programmes for entrepreneurs and workers.

*Yet the economic costs of formalization tend to discourage entrepreneurs ...*

It should be recognized that, from the perspective of individual entrepreneurs, there are costs of non-compliance with the law, such as fines and missed revenues in case of business closure. Yet there may also be perceived advantages to remain operating informally, i.e. unregistered by Government and invisible for tax authorities. Business owners who deliberately choose this path sense immediate advantages for their daily business operations. However, they often under-estimate the risks of operating informally. Some of the repercussions include ineligibility to public support in times of need or the absence of possibilities to sign contracts and seek legal redress. Some business activities fall outside the de jure regulatory framework without deliberate intent. Such is the case, for example, where the food processing industry is governed by strict

health regulations, confining activities to designated, certified workspaces, thereby excluding small-scale bakeries and fruit juice processing units which are often run by women from their homes. For others, in spite of operating an economic activity within the laws of the country, formalization may simply be too onerous and/or costly, representing an insurmountable financial obstacle for the survival of the business in the short-run. Given the circumstances, they can simply not afford to operate formally. An example is a small-scale construction enterprise in a competitive market with low business margins.

*... so Governments should increase their efficiency and accountability while lowering costs and increasing benefits of formalization, pacing each step.*

Some Governments may not be sufficiently transparent about the use of public resources. Weak governance, and lack of transparency and accountability may affect people's trust in the Government. It may also impede the effective implementation of laws, policies and compliance mechanisms. These aspects may discourage entrepreneurs to formalize and comply with the law. Enterprises are more inclined to formalize if they have confidence in public policies and the use of public resources. Therefore, it is important to strengthen institutions and governance.

Given the heterogeneity of informal businesses – with typically many survival-oriented units and far less aspirational entrepreneurs with potential for growth in developing countries - a differentiated approach is required. The right emphasis and sequencing of steps is essential, making the first group of units economically more viable before enticing them to fully formalize. Supporting some people, such as those engaging in survivalist type of activities, to organise in social and solidarity economy organisations can be an important step in a gradual process towards formalization.

For enterprises that are constrained to survivalist activities, the financial and administrative capacities to comply with regular social security contributions and tax obligations to local and national authorities are often too limited – even if the cost of one-time licensing would be manageable. For this category of units an adapted approach to formalization should be adopted, including the simplification and adaptation of administrative procedures geared towards this sub-segment of economic actors, in combination with targeted economic support.<sup>12</sup> The formalization of these types of enterprises should be understood as a gradual process, with successive

<sup>12</sup> ILO, [Extending social security to self-employed workers – Lessons from international experience](#), 2021. ILO, [Enterprise Formalization: Tailored registration, tax and social security requirements for MSEs](#), Thematic Brief No. 3/2021. ILO, [Policy resource package on extending social security to workers in the informal economy](#).

steps towards full integration. In this respect, One-Stop Shops and online platforms have become a successful vehicle to link and accelerate registrations with multiple Government agencies over time. Through these facilities, the gains of formalization should be clearly communicated and actively marketed to informal economic units.

Growth-oriented entrepreneurs are more likely to be driven by their perception of the net gain from formalization – and remaining formal. It is important that Governments clearly communicate, through websites and social marketing campaigns, the reasons and advantages of formalization. Clearly everyone has to abide by the law. Strengthening compliance is therefore an important mechanism to raise the level of formalization. But the sheer number of informal activities in some countries poses limits to enforcement. Emphasis should be placed on making registration and compliance simpler, faster and more rewarding which can be facilitated through digitalization.

*The formalization of enterprises should be extended to its workforce too...*

Bringing workers within the legal and institutional system, ensuring compliance with laws and regulations, making workers part of decision making process through social dialogue is an imperative for accessing decent work. Progressive formalization of enterprises is needed to formalize jobs and thus generate more secure working conditions and better social protection. This makes good business sense. Motivated, well-protected workers are more productive, fall sick and/or have accidents less frequently and are less likely to leave the enterprises for other opportunities.<sup>13</sup>

*... allowing efforts towards productivity improvements take root and make enterprises thrive.*

The competitiveness of enterprises depends to a great deal on the labour productivity of the workforce. The effectiveness of technology support, innovation, skills development, among others, is predicated on the motivation and capability of the workforce to adopt changes. Therefore, as part of policies towards formalization, Governments in consultation with social partners, should, together with the private sector, implement strategies for productivity improvement. These should include, *inter alia* support to the uptake of technologies for higher resource efficiency and the adoption of environmentally-friendly work place practices.

Incentives can facilitate such “greening” processes and help enterprises take advantage of new business opportunities in the green economy. Viewed in this way, formalization offers a triple dividend: more competitive enterprises, decent work and a better living environment.

*The role of social partners is paramount....*

To overcome informality as a barrier for decent work and sustainable development, its symptoms and causes need to be well understood. The design and implementation of formalization measures should be based on sound diagnostics and the in-depth analysis of available strategic options. Inclusive, well-informed social dialogue processes should underpin reform and concrete measures for improvement.

To this end, bi-partite and tripartite mechanisms and dialogue with workers' and employers' organizations should be promoted. Their capacity to contribute meaningfully to progressive formalization should be strengthened. Importantly, consultations with informal economy enterprises and workers should also be held to fully grasp the reasons for informality and the triggers for formalization. Through membership-based organizations, operators should be able to express their views and ensure that their voices are heard. Given the role of representative workers' and employers' organizations in social dialogue institutions and processes, it is important that these organizations further strengthen their relationships with and, where appropriate, extend their membership and services to enterprises and their organizations in the informal economy.

*.... setting an agenda for formalization that is comprehensive.*

The advance of enterprise formalization depends on the interplay of prevailing rules and regulations, economic and social factors, and individuals' circumstances. It is also closely related to a conducive environment in which enterprises can thrive and grow sustainably. All need to be taken into account when crafting a formalization strategy in tandem with support to enterprise development.

Improving the governance of formalization implies appropriate and well-coordinated legislation and regulations for business registration, taxation and competition. It should include effective inspection and compliance mechanisms, with transparency and accountability upholding a rights-based approach.<sup>14</sup> But this should not be an isolated effort. Rather, it should be part of a comprehensive policy framework

13 ILO, *Social Protection among Vietnamese SMEs: Implications for Firm Performance 2012-16*, 2019.

14 ILO, *A guide to selected labour inspection systems (with special reference to OSH)*, 2011.

that aims at raising the level of decent work across the economy, in all economic units.

The agenda would also include economic incentives for formalization as part of value chain development strategies, for improving access to financial services, to technology transfer, productivity improvement, cluster building and skills development, among others. These measures constitute a systemic approach to productivity enhancement at enterprise, sector and national level.

Social and individual determinants of formalization should be addressed too, recognizing the prevailing norms, trusts, segregation, stigmas, codes of conduct, habits, sense of autonomy, cooperation, social pressure, etc. in each society. Often overlooked, these cultural factors may have a decisive influence on behavioural patterns towards formality.

*Implementation needs to be carefully designed and timed ...*

Given the broadness of the formalization agenda and the time required to ensure the progressive formalization of all enterprises, the menu of strategic options is similarly large. Simplifying and reducing the costs of business registration is often one of the first steps, nowadays facilitated by digital technologies. But to entice entrepreneurs to formalize their venture often requires a well-designed awareness-raising campaign about the advantages, rights and obligations, as well as the repercussions of remaining informal. Professional associations and social networks should be mobilized to increase outreach and credibility.

*... adopting a systemic approach ...*

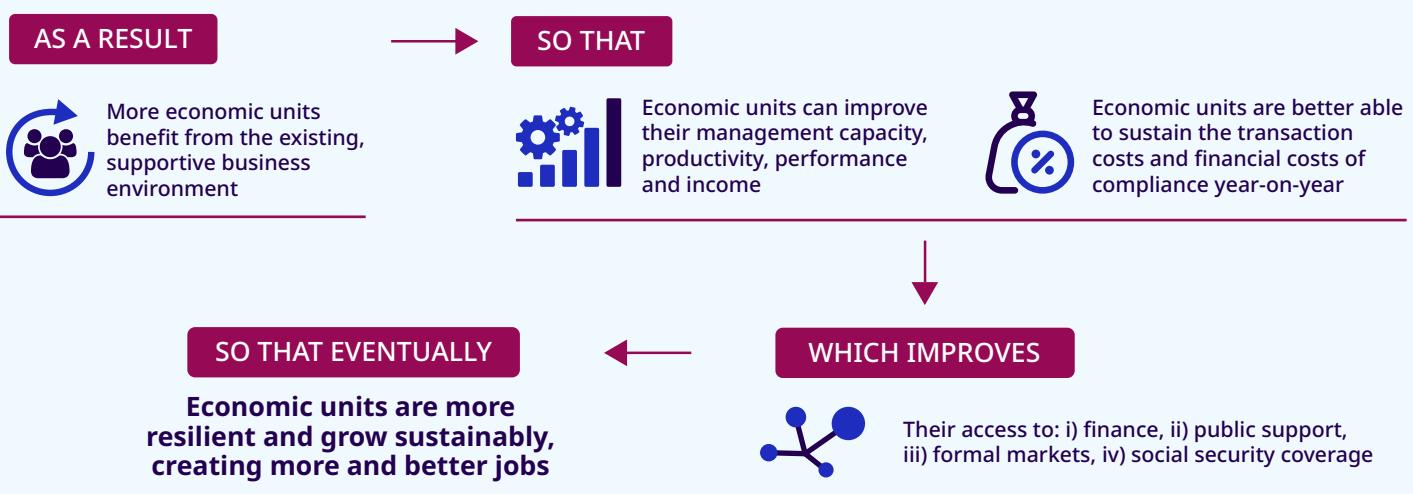
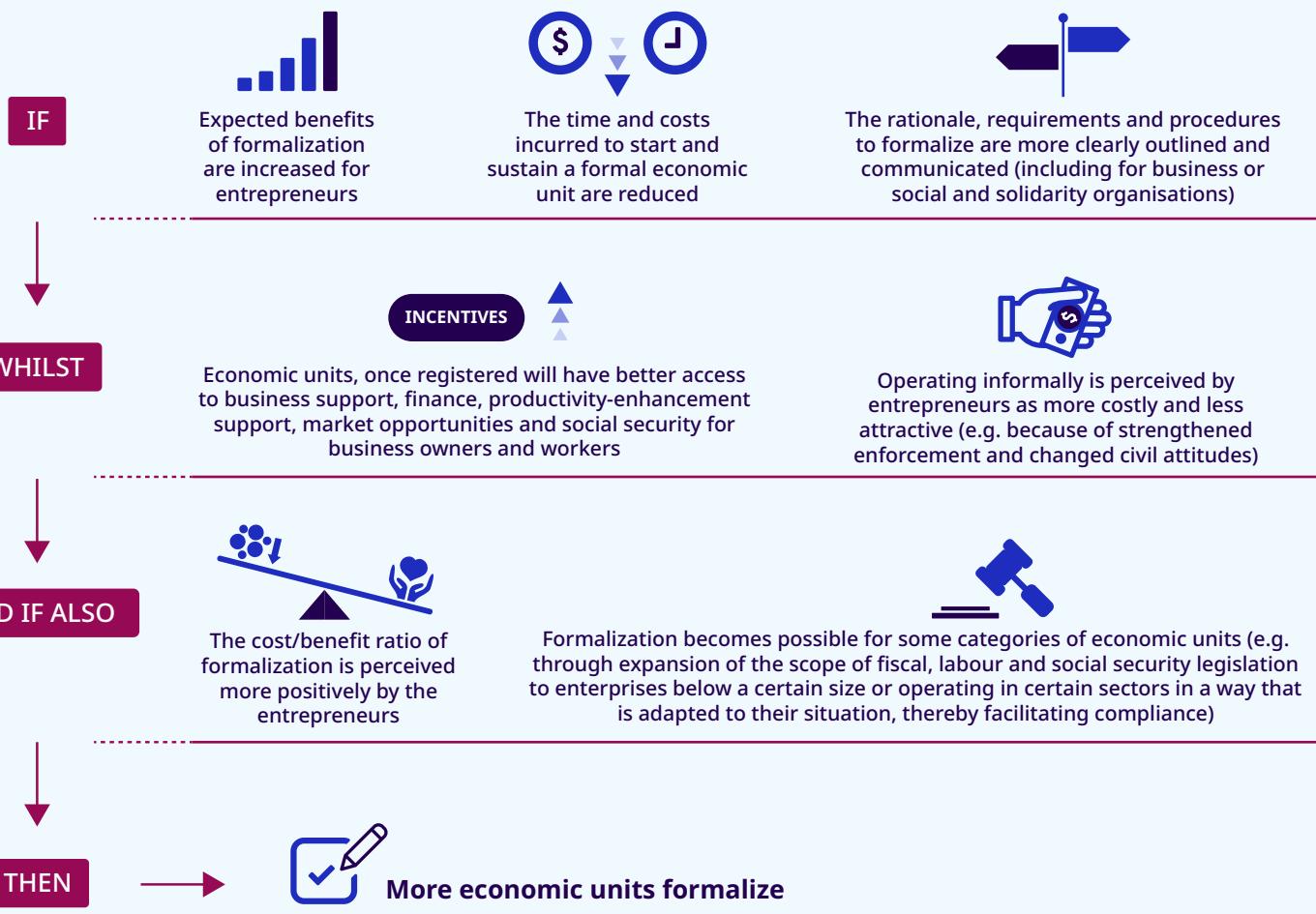
To be effective, such measures should be well-targeted and well-coordinated among all concerned stakeholders, as effective formalization spans across many thematic areas and as different groups of enterprises have different conditions and expectations. In fact, the diversity and precariousness among informal actors call for a multiple response that optimizes the balance between incentives, support and penalties.

A systemic approach should be adopted to address the root causes of informality and achieve sustainability and scale. This starts by recognizing the dynamics of informality and the specific situation of certain categories of entrepreneurs, for example those in rural areas, migrants and ethnic minorities. Measures should also recognize and address obstacles to certain groups such as start-up entrepreneurs, women, youth and social and solidarity economy organizations.

*... transforming enterprise formalization into a tool towards achieving sustainable development.*

As sustainable enterprises develop and prosper, they may be more likely to embrace climate-resilient, resource efficient business practices that help safeguarding natural resources for future generations. Besides, demand for sustainable consumer goods – in food, fashion, vehicles, energy – is growing at a steady pace. The notion that “Green Business is Good Business” is taking hold. Consequently, formalization strategies should consider environmental regulations too, as these are becoming more prevalent in response to degradation and the over-use of resources. In parallel, Governments are increasingly offering incentives for carbon off-set, the switch to renewable energy sources and the adoption of circular business models.

## How can enterprise formalization lead to sustainable enterprise development?



## How does the formalization of enterprises lead to more quality jobs?

