



► Transition from the informal to the formal economy - Theory of Change

February 2021

► I. Background

Today, more than six workers¹ among ten and eight enterprises² among ten in the world operate in the informal economy. Informality is thus a phenomenon of great magnitude which, contrary to the old forecasts, has not diminished over time and is even increasing in many countries. While more prevalent in developing countries, the informal economy exists in all parts of the world. Women are more exposed to informality in low- and lower-middle income countries and are often found in more vulnerable situations than their male counterparts.

Tackling informality is a very complex and long-term task that requires to address its root causes. Such causes are multiple and relate to the economic and institutional environment such as the inability of the economy to create quality jobs, an inadequate regulatory framework or a lack of transparency and accountability of public institutions. They also relate to the characteristics— that often interact —of the persons or enterprises concerned

such as the level of education, poverty or productivity. Possible causes of informality also include hazardous events such as climate catastrophes or pandemics.

This Theory of Change (ToC) doesn't pretend to describe the changes required to reduce all forms of informality in all contexts. For example, tackling informality among domestic workers or small farmers in a low-income country requires very different policy interventions than reducing informality among wage employees in formal enterprises in developed countries. This ToC intends to be an umbrella theory of change for the transition to formality that provides a framework that can inform the development of theories of change focused on a specific sector (e.g. construction), occupational group (e.g. street vendors), forms of informality (e.g. undeclared work in formal enterprises), policy areas (e.g. social protection) or socio-economic contexts.

► II. Meaning, objectives and processes of formalization

What does transition to formality mean?

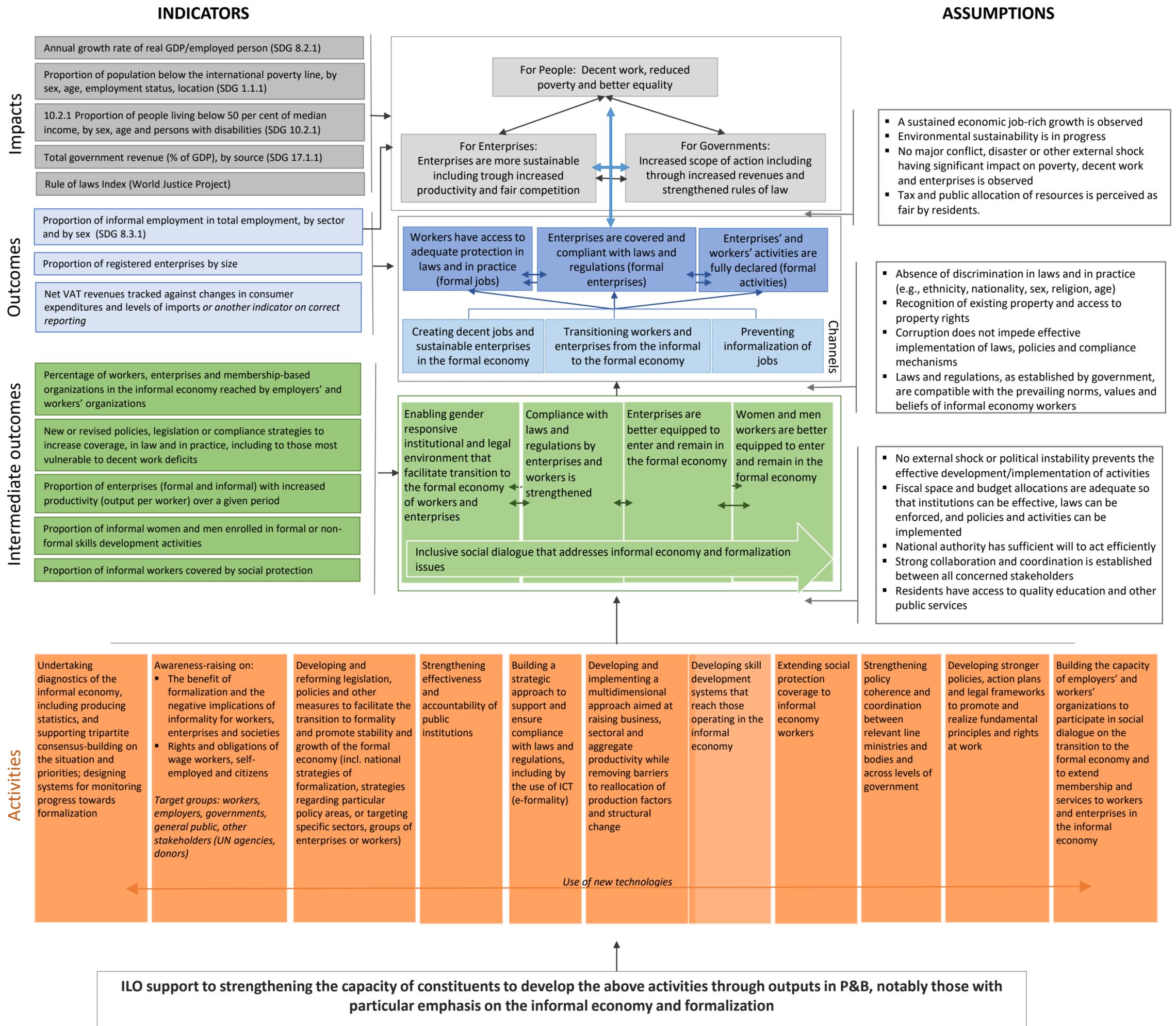
For enterprises, formalization means bringing them under the regulation with the advantages and obligations that this entails. It includes the extension of the scope of fiscal, labour and social security regulation to all enterprises without exception regarding the size, sector or other criteria, the legal recognition and registration of enterprises and compliance with legal requirements. For independent workers, the fact that their enterprises belong to the formal economy or not determines if they are also in the informal economy or not. For employees,

transition to formality means providing them with adequate labour and social protection. Depending on the situation, this means realizing one or several of the following actions: (1) extending legal coverage to those excluded or insufficiently covered; (2) providing an adequate level of legal protection (e.g. no exclusion from social insurance because of a threshold regarding working time) and (3) ensuring an effective compliance with laws and regulations. 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.

¹ In order to simplify the text, the term “workers” is used here to refer to all people in employment: employees, independent workers with or without employees and contributing family workers.

² In this TOC, “enterprises” is used as an equivalent to economic units that is the expression retained in Transition from the Informal to the Formal Economy Recommendation, 2015 (No. 204) Recommendation 204.

Transition from the informal economy to the formal economy — Theory of change



As shown in the figure, it would be wrong to consider that formalization processes are restricted to coverage by, and compliance with, laws and regulations. Increasing productivity is also, for example, a condition for the formalization of micro and small enterprises which provide close to 44 percent of global employment. Helping people to develop their full potential by allowing them to access risks mitigation or skills development measures is constitutive of many formalization strategies.

Why is transition to formality important?

Formalization is not an objective in itself but a necessary condition to reach very important objectives. Without formalization, access to decent work remains an illusion. Formalization reduces poverty and leads to greater equality among people. The formalization of enterprises, including through increased productivity and better market access, contributes to their sustainability and fosters fair competition in national and international markets. The formalization of enterprises is also a condition for an adequate labour and social protection of the workers they employ. More broadly, formalization benefits society as a whole because it enhances the government scope of action, notably by allowing increased public revenues and strengthening the rule of law. It also contributes to fairer societies by distributing rights and obligations among its members more equitably. Furthermore, government support in times of crisis, such as the COVID-19 pandemic, is significantly facilitated when they are in the formal economy. Formalization is also a condition for achieving several SDGs, including 1, 5, 8, 10 and 17.

► III. What needs to happen ?

Multiple strategies can be applied for facilitating the transition to formality

There is a strong variability of pathways to transition to formality depending on national circumstances, including public preferences, characteristics of the informal economy and labour market structure, existing legislation, policies and practices, institutional and financial capacity of public institutions. In practice and, in accordance with the objectives and principles of R204, multiple strategies can be adopted. Such strategies involve policies and measures that affect the environment/context in which economic activities take place, such as macroeconomic, commercial, industrial, tax, sectoral and infrastructure policies that influence notably productivity progress, business development, structural transformation and the generation of formal employment. They also include policies that

What about formalization processes?

Formalization can be pursued through three complementary channels which are the objectives of ILO Recommendation 204 concerning the transition from the informal to the formal economy, namely: 1) creating decent jobs and sustainable enterprises in the formal economy, 2) transitioning workers and enterprises from the informal to the formal economy, 3) preventing the informalization of jobs.

Reducing decent work deficits in the informal economy is one of the results of formalization but it is, at the same time, an enabling condition that facilitates transition to formality and, as such, it can be considered as part of the formalization process. Some workers and enterprises have the potential to formalize in the short run while, for others, this is not yet a realistic possibility. Addressing decent work deficits progressively reduces vulnerabilities and increases the capacity of workers and enterprises to enter into the formal economy in a sustainable way. For example, providing workers with basic social protection constitutes an enabling factor for their transition to formality by reducing their exposure to poverty, enhance their access to health care and enabling them to seize economic opportunities.

Being or becoming formal is not given for ever. Enterprise and job creation and destruction as well as transition in both directions between the formal and the informal economy, determines the size of the informal economy. Informality is a dynamic process that depends on multiple factors and forms of work that evolve over time. Policies should be responsive to such evolution.

affect the transversal drivers of formalization, such as those that strengthen social security systems, compliance mechanisms or labour market institutions, social dialogue, access to financial and other business development services, access to education and skills, infrastructures, etc. It also includes policies targeting specific categories of enterprises (e.g. MSEs), groups of workers (e.g. domestic workers, platform workers), types of informality (e.g. undeclared work in formal enterprises), or sectors.

In order to set adequate strategies, there is a need to understand the prevalent forms of informality and the prevalent drivers of informality and formalization in the country, and their variability among various groups of workers, categories of enterprises and local circumstances.

Interventions are more effective when they are combined and when they tackle different drivers of informality. Effective formalization strategies, in most of the cases,

combine interventions to increase the ability of the economy to absorb informal economy workers and enterprises (inclusion) but also to strengthen the ability of individuals and enterprises to enter into the formal economy (insertion). This two-way logic presupposes actions at two levels: at the level of workers and enterprises in the informal economy and at the level of the political and institutional environment. Strengthening the ability to comply is very important but it is also essential to strengthen the willingness to comply, that is not only a matter of individual choice but is largely driven by the perception of fairness and the accountability of institutions. Setting the right incentives (e.g. increasing benefits of becoming formal) and eliminating the obstacles (e.g. excessive costs, legislation too complex/ not adapted) to join the formal economy is in this context essential.

In recent years, new technologies, notably ICT, have been increasingly used to foster transition to formality. They can notably contribute to simplify and reduce costs of registration of enterprises and employment, facilitate access to social security benefits and compliance with laws, boost productivity, and help to give a voice to those working in the shadows.

Formalization strategies can focus, often as a start, on specific sectors, groups of workers, categories of enterprises, particular policy areas or intervene on several aspects at the same time. Even if focused on specific target groups, formalization strategies, to be effective, need, in most of the cases, to act on some of the transversal drivers of informality that could constitute impediment for all groups to become formal. The choice for entry points can be grounded on various factors which may include the prevalence of certain forms of informality, a higher level of exposure to informality for certain groups (workers or enterprises), priority groups or sectors as part of the national policy agenda, potential for successful formalization (showcases) as part of the learning and long-term process of formalization.

Formalization strategies should be gender responsive. For example, women perform the majority of care

responsibilities. This affects their choice of work, their pay and often pushes them into informal employment. Improving access to affordable care services for children, older persons and other dependent sick or disabled persons can therefore contribute to their transition to formality.

The importance of social dialogue

Social dialogue is instrumental in ensuring that policies address informality efficiently, particularly with regard to transition to formality. Tripartite mechanisms and consultations with workers' and employers' organizations should be promoted notably when identifying the nature of the informal economy, establishing diagnostic, elaborating action plans or when designing and implementing policies for a particular group of workers and enterprises. Informal economy workers and enterprises should have the possibility to express their views and defend their interests, notably through their membership-based organizations, on policy measures that will affect them directly. Their inclusion at an early stage of the design process will enhance the effectiveness of such measures. 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, workers, enterprises and their organizations in the informal economy.

Transition to formality is a long term process

Formalization results from a complex, long and gradual process. It is important to develop and monitor progress, develop and adjust policies and interventions at the level of intermediary objectives and of activities which all contribute in a coordinated way to build the intended final impact.

► IV. The actors to be involved

Tackling informality requires acting on several of its drivers, some of them being beyond the world of work. This calls for coordinated action between several ministries and other public bodies, and close consultation and participation of the social partners and the informal economy organizations concerned. The ministries and public bodies responsible for labour, social protection, enterprise development, the social and solidarity economy, finance and economy, welfare, rural development and industry used to be the main public contributors and actors of the formalization process and should be the main supporters of the coordinated development of policies and strategies.

Actions can also be taken by the social partners without implying the governments. They can also be realized directly by informal economy organizations, sometimes in cooperation with workers' or employers' organizations.

To ensure cooperation between UN Agencies, it is necessary that the formalization of the informal economy be integrated into national United Nations Sustainable Development Cooperation Framework systems. The IMF, World Bank and Regional Development Banks are often involved, in cooperation with the governments, in the development of fiscal and monetary policies that may have strong influences

on the formalization process. It is then important that interventions to support the transition to formality be coordinated with them. When the informal economy

is grounded on cross border movements of persons or goods, the cooperation between countries is also required.

► V. ILO's contributions

ILO's actions are aligned with Recommendation 204 on the transition from the informal to the formal economy (2015). They take into account International Labour Standards, notably those included in the annex of the Recommendation 204. This includes transversal interventions, such as supporting the development of a diagnostic of the informal economy, or the design of a national integrated strategy of formalization, as well as measures directed towards specific sectors such as domestic work, groups of workers, or enterprises such as micro and small enterprises, or related to a particular

policy area such as the extension of social protection to informal economy workers or strengthening compliance mechanisms. The ILO also contributes to support inclusive social dialogue processes and the strengthening of social partners' capacities to participate in social dialogue on the transition to the formal economy and provides services to workers and enterprises in the informal economy. To sum-up, activities supported by the ILO lead to the achievement of intermediate outcomes.

► VI. Variables and assumptions

The success of formalization strategies also depends on a number of variables that are not part of the expected chain of changes and are presented in the figure as a set of assumptions between the different blocks. assumptions relate to context, belief, other policies than formalization

and a variety of other subjects. They are most often time and context specific. Only assumptions that have been identified as the most important are presented in the figure.

We would be interested to know your views and eventual observations regarding this theory of change on transition from the informal to the formal economy. Please don't hesitate to send your comments to inwork@ilo.org.

Contact details

International Labour Organization
Route des Morillons 4
1211 Geneva 22
Switzerland

T: +41 22 799 6754
E: inwork@ilo.org
www.ilo.org/informaleconomy