



# Enterprise formalization: Fact or fiction?

A quest for case studies



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Registered offices Bonn and Eschborn  
Dag-Hammarskjöld-Weg 1–5  
65760 Eschborn, Germany  
Phone: +49 61 96 79-0  
Fax: +49 61 96 79-1115  
Sector Project "Innovative Approaches for Private Sector Development"  
private.sector@giz.de  
www.giz.de/privatwirtschaft

On behalf of

**Federal Ministry for Economic Cooperation and Development,  
Sustainable Economic Policy; Financial Sector (Division 313)**

Dahlmannstraße 4  
53113 Bonn, Germany  
Phone: +49 (0) 228 99535-0  
Fax: +49 (0) 228 99535-3500  
poststelle@bmz.bund.de  
www.bmz.de

**International Labour Organization**

Small Enterprise Programme (EMP/SEED)  
Job Creation and Enterprise Development Department  
Employment Sector  
International Labour Office  
4 Route des Morillons  
CH-1211 Geneva 22  
Switzerland  
Phone: +41 22 799 6862  
Fax: +41 22 799 7978  
E-mail: seed@ilo.org  
www.ilo.org

**Author**

Koos van Elk and Jan de Kok,  
in cooperation with Jessica Durán and Gert-Jan Lindeboom

**Design**

andreas korn visual communication, Dar es Salaam

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Koos van Elk and Jan de Kok,  
in cooperation with Jessica Durán and Gert-Jan Lindeboom

This study has been commissioned by International Labour Organization (ILO) and Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH on behalf of the Federal Ministry for Economic Cooperation and Development (BMZ)

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# Summary

## Background

Governments across the world try to reduce the size of the informal sector, because of many negative aspects that are associated with informal enterprises both at macro and micro level, e.g. poor labour conditions, a poor tax basis and poor coverage of social protection. One of the ways to reduce the size of the informal sector is by stimulating the formalization of informal enterprises.

To support governments in the design and implementation of their strategies regarding the formalization of informal enterprises, Internationale Labour Organisation (ILO) and Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH on behalf of the Federal Ministry for Economic Cooperation and Development (BMZ) wanted to know what is actually known about what works and what doesn't. This study presents an overview of the current debate on formality and formalization of informal enterprises and the results of a search for case studies that provide credible proof of the quantitative effects of different types of formalization policies.

## The current debate on informality of enterprises

Since the early 1970's, the term (urban) informal sector was used to refer to the group of enterprises that were not considered to be formal. More recently the concept informal economy was introduced, which refers to both informal enterprises and informal employment. This study focuses on informal enterprises. In the literature informal enterprises are usually characterised in terms of the primary objective of the entrepreneur, production factors involved and the organization of the production process (including legal form, registration and compliance with different regulations with regard to labour conditions). When it comes to definitions, 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) and/or firm size. Since different studies use different definitions, data and results are not easily comparable.

## Reduction of informal sector: Why and how?

The transition from a large informal economy to a large formal economy can have positive effects on various levels:

- 1 Formal enterprises tend to perform better than informal enterprises. At macro level, an increase in the number and/or size of formal enterprises translates into higher GDP levels and growth rates.
- 2 Many employees will benefit from such a transition. Because of higher labour productivity, higher wages and better working conditions are possible.
- 3 An increase in the country's tax revenues, which in turn can be used for various public programmes.

- 4 A transition from an informal to a formal economy could improve the general attitude towards government, which would in turn have a positive effect on the intention to comply with regulations.

These factors have the potential to reinforce each other, e.g. a larger tax base allows higher government investments in infrastructure, education and the rule of law.

So there are strong arguments in favour of applying well-designed policies to promote the transition from an informal economy to a formal economy. Basically, this can be obtained in four different ways:

- ▶ Informal enterprises may be motivated to formalize by lowering the costs of becoming (and remaining) formal.
- ▶ Another way to motivate informal enterprises to formalize is by improving the benefits of being formal.
- ▶ The development of the formal economy may be stimulated by improving the general business environment. Amongst others, this implies that policies to lower costs and improve the benefits of formalization (as mentioned in the previous two bullets) should also target formal firms.
- ▶ Strengthening law enforcement.

This study focuses on the first two policy strategies.

### **The choice between being a formal or an informal enterprise**

It is often assumed that the choice between becoming formal or informal depends on the expected costs and/or benefits for an enterprise of becoming and being formal.

- ▶ Costs associated with becoming and remaining formal include entry costs (registration costs); taxes, fees and social contributions; and compliance costs (e.g. with labour regulations and property registration).
- ▶ Benefits associated with being formal include a reduction in the risk of closure or having to pay fines or bribes; that it is easier to establish an enterprise at a permanent location; that formal enterprises have better access to (public) business development services, financial services and insurance services; and get access to more and different markets.

### **Three views on informality of enterprises and its consequences**

Which of the various costs and benefits are the main causes of informality, and what does this imply regarding the consequences? Although this is still a topic of debate, three main views can be distinguished in the literature:

- ▶ exclusion view, also known as romantic view.
- ▶ exit view, also known as McKinsey view.
- ▶ dual economy view.

These views differ in their diagnosis of the main causes of informality, the characteristics of informal entrepreneurs and (consequently) on the best way to make the transition from a large informal economy to a large formal economy.

### **The exclusion view**

According to the exclusion view, the large share of informal enterprises can be explained by the high entry costs and the high levels of taxes, fees and/or contributions that are associated with becoming and/or remaining formal. If not for these costs, most informal firms would choose to formalize. In many aspects, informal firms do not differ much from formal firms of similar size. As far as their skill and competence levels, their motivation, and therefore their potential productivity are concerned, they are comparable. This view implies that many informal firms can potentially contribute to economic growth. The policy implications of this view are straightforward: a reduction of the high level of entry costs and of taxes, fees and social contributions would lead informal firms to switch into formality and potentially increase the overall productivity of the economy.

### **The exit view**

Proponents of the exit view assume that enterprises do not just consider the costs of formalization, but compare the costs with the benefits. For informal enterprises, the benefits of formalizing are not large enough to compensate for the costs of formalizing. This implies that they are not productive enough to survive as formal enterprises. According to this view, the presence of informal firms has a negative effect on macro-economic growth. Consequently, rather than stimulating informal firms to formalize themselves, they should be forced to end their economic activities altogether, in order to make room for formal and more productive enterprises. An important policy implication of this view is therefore to increase law enforcement to eradicate informal firms.

### **The dual economy view**

According to this view, the main explanation for the large number of informal enterprises is the lack of wage jobs in the formal economy. Many people start a small, informal enterprise, not because they want to become entrepreneurs, but because of a lack of suitable wage jobs and the absence of social security systems. Often, these entrepreneurs do not have the necessary skills (education) to become successful entrepreneurs. In combination with a lack of motivation to grow, this implies that the benefits of formalization will be very low for these necessity/subsistence entrepreneurs.

Although informal firms provide subsistence to a vast number of people without any alternative means of income, these firms are generally speaking not able to generate economic growth, irrespective of whether they would formalize or not. Therefore, an important policy implication of this view is, that governments should not focus on formalizing the currently informal firms, but on stimulating the creation of new, formal firms and improving the conditions for the incumbent formal enterprises to stimulate employment growth. This requires policies improving the general business environment. This would increase the supply of wage jobs in the formal economy, thereby offering many subsistence entrepreneurs a better-paid alternative.

## Empirical findings

A fundamental question is whether policies to stimulate informal enterprises to formalize can be successful at all. This depends on *when* and *how* enterprises decide to be (come) formal or informal. The outcomes of a few empirical studies suggest that the majority of enterprises make this decision only once, at the start of the enterprise. If this is indeed the case, it may prove very difficult to stimulate existing informal firms to formalize.

The question *how* enterprises decide to be (come) formal or informal, is basically the question which of the three main views is the correct view. This is probably not the correct question; rather, it is which of these views applies to the largest share of the informal enterprises in a given economy. There are several indications that in particular the exclusion view does not seem to apply to a large share of informal enterprises, and that the dual economy view applies to the largest share of the informal enterprises.

Nevertheless, many different policies have already been implemented throughout the world to support the formalization of informal enterprises. These policies can be classified in terms of their domain and the costs and benefits of formalization that are being targeted. A highly relevant question is then, whether some of these policy types are more successful than others. Given our current state of knowledge on the effectiveness and efficiency of different policy types and in particular the lack of available studies that examine the outcome of specific policies using adequate econometrical methodologies, this question cannot yet be accurately answered.

Still, there are some empirical findings that increase our understanding of what works and what doesn't:

- ▶ Although not all business entry reforms succeed in raising the number of firm registrations, some do. For these reforms, increases in firm registration of 5% are reported.
- ▶ For single reforms that aim to increase firm registrations by reducing the costs of formalization, the reduction of payments has to be at least 50% to have a significant effect on the number of registered businesses. Single reforms that aim to increase firm registrations by reducing the length of the procedure can have significant effects when the length is reduced by 15%.
- ▶ When several reforms are combined (for instance reducing both the length and payments of registration), less drastic reductions are required because of the synergistic effect.
- ▶ In countries with weaker business environments, the extent of the reform has to be larger in order to influence business registration.

## Available evidence on the impact of policies to formalize informal enterprises

The aim was to identify cases that provided credible quantitative evidence on the causal effect of formalization policies on the number of informal firms that formalized. A first

structured literature search resulted in 123 publications. However after a first assessment only a very limited number of relevant studies remained because many publications:

- ▶ focussed on informal labour rather than informal enterprises.
- ▶ did not focus on the relation between policies implemented and results obtained.
- ▶ did not provide credible quantitative evidence of results obtained by a specific policy.

Six cases complied with these criteria to a reasonable extent. These cases are presented in Chapters 4–9 of this report:

**1. Monotax (Argentina)**, this concerns the simplified regime for small taxpayers that consists of a single tax with a flat monthly fee, which replaces income tax, value added tax (VAT) and social security contributions. The Monotax aims to reduce the burden for small taxpayers that cover a significant part of all salaried employment in Argentina. In 1998, a simplified system was suggested with as one of the objectives to fight informality and evasion. The number of registered tax payers has continuously increased since the introduction of the Monotax: 642,167 in 1998 and 2,020,000 in 2009.

**2. SIMPLES (Brazil)**, introduced by the Brazilian government in 1996, is a programme with reduced tax rates and tax regulations for Brazilian micro firms with no more than 5 paid employees. SIMPLES can be interpreted as a measure reducing the costs of formalization. This case study examines to which extent the decision to formalize eligible firms was affected and how this decision affected firm performance. An urban informal sector survey of 1997 was used that targeted individuals in urban areas who claim to be self-employed or owner of an enterprise with up to 5 paid employees. Main findings are:

- ▶ The formalization degree of enterprises that started just before the introduction of SIMPLES is considerably lower than that of enterprises that started right after the introduction of SIMPLES.
- ▶ 72% of firms that attempted to register, reported having no difficulties in the process. This suggests that in Brazil, barriers to entry are not the principle drivers of informality.
- ▶ Introduction of SIMPLES had significant positive effects on the level of formality: The license to operate showed an increase of 7%–12% and the registration with tax authorities an increase of 3%–7%.
- ▶ The size of these positive effects tends to be larger for firms with paid employees.
- ▶ Formalized firms show revenue and profit levels that are roughly 50% higher. The SIMPLES case shows that reducing the costs of being formal can have significant positive effects on the degree of formality and suggests that policies to promote the formalization of enterprises may be more effective if they focus on start-ups.

- 3. Individual Micro-entrepreneur (Brazil),** (also) in Brazil there is a strong correlation between 'size of company' and prevalence of informality. The Individual Micro-entrepreneur (MEI) is an innovation of the Brazilian tax system approved in December of 2008 allowing the formalization of self-employed at low costs, with pension coverage for the micro-entrepreneur and his/her family. This large programme MEI addressed a total of over 10 million informal entrepreneurs in Brazil, and it has managed to register 1.4 million workers until July 2011. One of the main advantages of this law is the registration in the National Register of Legal Persons (CNPJ), which facilitates the opening of bank accounts, the application for loans and the issuing of invoices.
- 4. Municipal reforms (Brazil):** This case study uses administrative data to evaluate the impact of Minas Fácil Expresso, a programme which attempted to expand a business start-up simplification programme to more remote municipalities. The authors estimate that the reform (opening of local offices) resulted in a statistically significant negative effect: namely a reduction in registration in the municipalities concerned. Next to an initial effect that might be due to delays in registration during an adjustment period until the new system is running smoothly, an additional reason might be that some firms might not want to register with all three levels of government considered (municipal, state and federal procedures). Before they had the option of registering with only one or two of these levels, thereby evading fees and taxes associated with the others. Also no significant impact on tax revenues was established
- 5. Law 1429 (Colombia):** This law of 2010 consists of a wide range of measures concerning the formalization of both employment and businesses. The law defines small companies as having no more than 50 workers and deals with six different areas of interest, a.o.: (1) business development; (2) reduction of costs during first years of existence; (3) employment generation for specific target groups; (4) reducing red tape. Unfortunately, the law did not foresee a specific monitoring system and it is complicated to know exactly the number of companies which have benefited from the law and evaluate its impact. In 2011 nearly 175 000 new companies were constituted in Colombia, almost 10% more than the year before, but only 2% more than 3 years before. Almost 145 000 of these new firms (83%) had the opportunity to benefit from reductions concerning the trade register. In addition just over 87 000 already existing small companies benefited from the amnesty, meaning they did not pay for the annual trade register. Overall, this implies that nearly 232 000 small companies were able to benefit from discounts related to the trade register derived from the Law 1429. However it is not entirely clear whether the effect was fully due to the Law 1429.
- 6. An experiment in Sri Lanka:** The majority of firms operating in Sri Lanka are informal, even if these firms employ paid workers. A survey showed that firm owners generally do not know facts related to registration, such as actual costs or process length. Four experiments to measure the latent demand for formalization were implemented: offering informal firms after formalization a financial compensation ranging from 9 to 350 USD. In statistical terms, the first intervention of 9 USD did not yield significant results. The compensation of 350 USD however produced significant high results. Most of the firms that did not register reported to have started the registration

process, only to find out that they needed the permission of their land owner, often the government. This qualitative finding is confirmed by quantitative data, showing that formalization is much lower for firms operating on public land. Also surveys were conducted in the years after the experiment: 36% of registered owners did not see the benefits of registration. 20% answered that it was beneficial for the image of their firm or reported to feel more secure and protected. 10% claimed that it may help to obtain a loan; very few however reported to actually have obtained a loan or government contract as a result of formalization. It should however be noted that it is not really surprising that only a few enterprises actually obtained a loan. Because only a minority of small enterprises in general – also in developed countries – are really ambitious and growth oriented and hence in need of external finance to further develop and innovate. The experiment showed that payment comparable to 2-months profits is enough to induce firm owners to register. In fact, in many cases where registration did not follow, this was due to practical constraints, in this case the requirement of approval of the landowner. This study shows formal registration to be primarily a rational decision. Financial payments have an effect on registration, even when perceived benefits are relatively low.

Despite the fact that only a few case studies have been discussed, the following generalizations can be made:

- ▶ Success of reforms is context specific, as the definition and the characteristics of “the informal sector” can greatly differ from one country to another. Therefore there is a need to analyse the informal sector before designing the reform agenda with specific policy measures.
- ▶ It is important to carefully look at the costs of formalization, e.g. the direct costs in terms of time to be spent on formalities (compliance costs) and fees and taxes to be paid. In most cases, it is however not sufficient to limit policies to cost reductions. In addition, one should for example also look at the extent to which the entrepreneurs in the informal sector are properly informed on the steps to be taken to formalize their business and the consequences it will have etc. And in addition to the costs, the benefits of formalization for enterprises should also be determined and communicated to allow entrepreneurs to get a better idea of the cost-benefit ratio.
- ▶ Innovative tools to increase formalization could be considered, such as a lottery with free tickets for those having paid taxes or linking formalization to relatively easy access to social protection for entrepreneurs and workers in micro enterprises.
- ▶ A necessary condition for any policy to become a good practice is that the policy must be implemented correctly and run by competent staff.
- ▶ Finally, there is a general lack of data and evaluations that convincingly relate good practice examples to the actual number of enterprises being formalized as a result (casual effects properly analysed).

# 1 Introduction

## Background

It is widely accepted that a large informal economy has all kinds of negative economic effects, at macro level as well as micro level, e.g. including poor labour conditions, a poor tax basis, poor coverage of social protection and a negative influence on macro-economic growth. Hence, many policies and programmes across the world try to reduce the size of the informal economy, amongst others through all kinds of policies and programmes to stimulate the formalization of informal enterprises. At the end of the first decennium of this century, the size of the informal economy was showing a negative trend, but it is still considerable with an unweighted average value of 33% of official GDP (Schneider et al, 2010).

The term informal may refer to informality of employees but also of enterprises. This study focuses on informal enterprises, or rather policies aimed to formalize informal enterprises.

## Objective and research tasks

To support governments in the design and implementation of such policies and programmes, ILO and GIZ want to present an overview of our current understanding of these issues and verify what is actually known about what works and what doesn't. ILO and GIZ have translated this objective into the following research tasks:

1. Provide an overview of the current debate on the formalization of enterprises in developing and emerging countries.
2. Search for recent publications with credible empirical evidence on the impact of policies (at microeconomic and/or macroeconomic level) that aim to stimulate informal enterprises to formalize.
3. Provide case studies, based on a selection of the most relevant identified publications.

Since informal enterprises are predominantly found amongst the smallest enterprises, this study focuses on policies that target the smallest enterprises: micro and small enterprises or MSEs<sup>1</sup>.

## Structure

Following this introduction, Chapter 2 contains an overview of the current debate on informality. Formalization refers to the process whereby informal enterprises become part of the formal sector. Hence a basic question is how the formal and informal sectors are defined and distinguished. In the literature a wide variation of definitions is being used. In analysing the selected case studies we have to use the definition that was used in formulating the policy measure being studied and in the study describing its effects. However we will still provide a more general overview of the different variations used in order to put these case studies in context.

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<sup>1</sup> See Appendix 2 for a discussion on common definitions of the size class of the smallest enterprises.

In Chapter 3 we present the approach to and the results of our literature search for recent publications<sup>2</sup>. Amongst others, we will discuss the lack of quantitative evaluation studies that include microeconomic and macroeconomic effects of policies encouraging the formalization of informal MSEs. In Chapters 4 to 9 we present the case studies found that satisfy the criteria set to a reasonable extent. The main lessons learnt from the various cases are listed in Chapter 10. Only main lessons per case are presented because the cases considered here are not providing a representative overview of all formalization efforts in different continents.

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<sup>2</sup> A detailed description of the literature search for case studies can be found in Appendix 1.

## 2 An overview of the current debate on informality of enterprises

### 2.1 Informal sector versus informal economy

Since the early 1970's, numerous studies have appeared regarding the (urban) informal sector. Originally, the informal sector was conceptualized in terms of enterprises and contained all enterprises that were not considered to be formal. Later, it became clear that this concept did not cover all informal activities within an economy<sup>3</sup>. As a reaction, the concept of the *informal economy* was introduced (Portes, Castells and Benton, 1989; Bangasser, 2000, p. 25; ILO, 2002). Basically speaking, the term 'informal economy' refers to all economic activities, by economic units as well as by individual workers, that are – in law or in practice – not covered or insufficiently covered by formal arrangements. As such, it covers both:

- ▶ informal enterprises, and
- ▶ informal employment.

This study focuses on informal enterprises, and in particular on policies to support informal enterprises to formalize themselves. Informal activities (including informal employment) by formal enterprises are outside the scope of this study.

### 2.2 Definitions and measurements of informal enterprises

Although there seems to be a broad consensus what the characteristics of informal enterprises are, there is less consensus about which of these characteristics should be seen and used as the defining characteristics. In this section we present various views on how informal enterprises should be defined and/or measured<sup>4</sup>.

#### Main characteristics

In the literature, the population of informal enterprises is often described by referring to their primary objective, the production factors involved and the organization of the production process (Ishengoma and Kappel, 2006; ILO, 2012):

- ▶ Primary objective:
  - Informal enterprises are often associated with subsistence entrepreneurship (see also Bruhn and McKenzie, 2013b) or necessity-based entrepreneurship (see also De Kok et al., 2013). The primary objective is often just to generate employment and incomes to the persons concerned, without a motivation to strive for growth or create a large enterprise (ILO, 2012, page 11).

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3 Amongst others, it did not cover informal activities by formal enterprises, such as not reporting all economic activities (to reduce VAT payments), not registering all of their employees (to reduce taxes and social contributions) and trading with informal suppliers.

4 As is customary in most of the empirical research, informality is treated as a dichotomous variable in this study. The end of this Section 2.2 however includes a brief discussion on different levels of informality.

- ▶ Production factors:
  - Informal enterprises are relatively often home-based or without a permanent physical location.
  - Informal enterprises often apply labour-intensive production methods.
  - Their employers and employees have relatively low educational levels.
- ▶ Organization of the enterprise:
  - Informal enterprises employ only a few (if any) employees.
  - Informal enterprises are not set up as separate legal entities that can be distinguished from the owner(s) of the enterprise.
  - They show a lack of compliance with government regulations<sup>5</sup>, in particular regarding registration with various authorities, payment of taxes and social contributions, and labour regulations.

The absence of adequate formal registration has several implications, for example regarding the legal status of the enterprise (without formal registration, an enterprise cannot be constituted as a separate legal entity independently of its owner(s)) and regarding property rights. The combined effect of labour-intensive production methods and relatively low levels of human capital result in relatively low levels of labour productivity of informal enterprises<sup>6</sup>.

Another implication is that it is difficult for governments to actually enter into a dialogue with informal enterprises. This makes it difficult to judge what exactly the reasons are for them to remain informal, and therefore it becomes difficult to design and implement the right policies.

### Defining characteristics

This broad characterization presents a picture of typical informal enterprises, but is difficult to use for a precise definition of informal enterprises. Most studies define informal enterprises based on one or several characteristics of the organization of the enterprise. For example, according to the ILO's statistical update on employment in the informal economy (ILO, 2011), enterprises should be classified as informal if they meet the following two conditions<sup>7</sup>:

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5 Notice that informal is not the same as illegal. Although the organization of the production process may fail to meet all legal requirements, the products or services that are provided by informal enterprises are in themselves not illegal (see also Schneider and Enste, 2000).

6 A reversed causality is also possible: for enterprises with low productivity levels, the benefits of becoming formal may be so small that they prefer to remain informal (Fajnzylber et al., 2011; Bruhn and McKenzie, 2013b). See also paragraph 2.3.

7 The following formulation is used: "the informal sector consists of unregistered and/or small unincorporated private enterprises" (ILO, 2011, page 12).

- ▶ they are unincorporated<sup>8</sup>,
- ▶ they are either unregistered<sup>9</sup> and/or small.

In empirical studies as well as in policy measures, there is usually a limited amount of information available that can be used to determine the formal status of individual enterprises. In these cases, it is customary to define informal enterprises in terms of only one or two defining characteristics. These are mostly related to the lack of compliance with government regulations and/or to firm size.

### **Informality as lack of compliance**

In many studies, the lack of compliance with government regulations is seen as the main defining characteristic of informal enterprises. Informal enterprises are defined as enterprises that do not comply with government regulations.

Since there are various types of government regulations, this allows for various specific definitions of informal enterprises, for example:

- ▶ Informal enterprises are enterprises that are not registered with local and/or national authorities (Fajnzylber et al., 2011).
- ▶ Informal enterprises are enterprises that do not pay (all) taxes and/or social contributions (Fajnzylber et al., 2011).
- ▶ Informal enterprises are enterprises that are not registered for relevant municipal licenses and with the tax department (Bruhn and McKenzie, 2013b).

### **Informality as synonym for firm size**

Another often-used indicator of informality is firm size. Firm size can be measured relatively easy (especially in surveys) and it tends to be correlated with other aspects of informality. For example, De Mel et al. (2013)<sup>10</sup> examine the relationship between firm size and the following types of registration in Sri Lanka:

- ▶ license at municipal level (PS or UCMC).
- ▶ license at division level (DS).
- ▶ register with Ministry of Labour for the Employee's Provident Fund (EPF) and the Employee's Trust Fund (ETF) for larger firms with paid workers.
- ▶ register for VAT.

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8 An enterprise is unincorporated if it is a unit that is not constituted as a separate legal entity independently of the individual (or group of individuals) who owns it, and for which no complete set of accounts is kept.

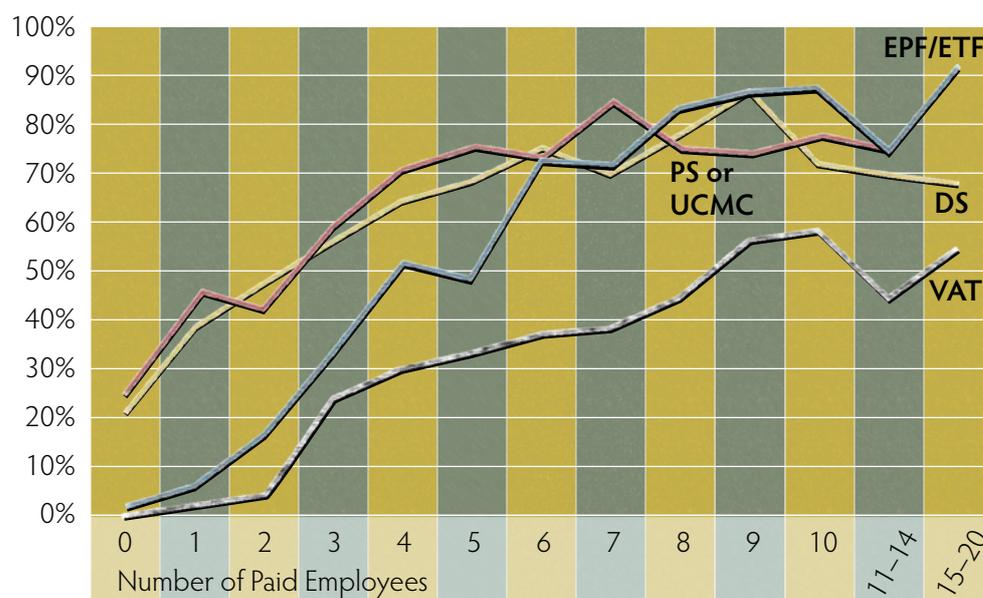
9 An enterprise is unregistered when it is not registered under specific forms of national legislation (e.g. factories' or commercial acts, tax or social security laws, professional groups' regulatory acts).

10 This study forms the base for case study 6 (Chapter 9).

They find that registration rates increase with firm size, independent of the type of registration (Figure 1.1).

**Figure 1.1**  
The relation between registration rates and firm size, in Sri Lanka

Source: De Mel et al. (2013), Figure 1



These results might suggest that firm size is a valid and available indicator of informality. Using firm size as an indicator of informality has however also received critique. If firm size is the only criterion used, informal enterprises are just the smallest size class in an economy<sup>11</sup>. And although firm size is strongly correlated with other aspects of informality, the correlation will never be perfect: even if the majority of micro firms would be informal and the majority of large firms would be formal, it does not apply to all firms from these size categories. Some micro firms will be registered and adhere to all other characteristics of formal firms, while some medium-sized firms may show many characteristics of informal enterprises. Furthermore, a large majority of formal enterprises are small (De Kok et al., 2013). Finally, the choice of the exact size limit is more or less arbitrary. Hence, it has been argued that firm size alone is not sufficient to define informal enterprises (ILO, 2012, p. 17).

### Establishing informality using several criteria

In practice, the identification of formal enterprises is often based on a combination of the firm size criterion with another criterion. For example, the World Bank Enterprise Survey defines formal enterprises based on firm size, but also (implicitly) on firm registration. Ayyagari et al. (2011) report that the sample frames for the countries that participate in the World Bank Enterprise Surveys impose a minimum enterprise size of 5 employees “so as to limit the surveys to the formal economy.” (Ayyagari et al., 2011, page 6, footnote 4). However, since this survey (as is customary) uses existing registrations<sup>12</sup>

<sup>11</sup> In the case of our study, this would imply that policies that succeed in motivating informal firms to formalize themselves are simply policies that succeed in stimulating firm growth amongst micro and small enterprises.

<sup>12</sup> Generally speaking, the World Bank Enterprise Surveys obtain contact information from a country’s statistical office, although sometimes other sources are used (for example, tax authorities, business licensing authorities or lists maintained by the Chamber of Commerce) (Ayyagari et al., 2011).

to obtain contact information, this suggests that all participating enterprises are formally registered<sup>13</sup>.

### How many informal enterprises are there?

Quantitative data on the number of informal enterprises (and their size) is hardly available. For example, in a study amongst 132 countries to collect data on the number of informal enterprises, only 16 of these countries could provide estimates (Kushnir et al., 2010). To make matters worse, differences in the definitions used make it very difficult to compare the available data. Nevertheless, it is clear that in many countries employment in the informal economy is considerable (World Bank, 2012). For example, India is reported to have approximately 1.6 million registered micro, small and medium-sized enterprises (MSMEs), compared to 26 million unregistered MSMEs (Kushnir et al., 2010).

These findings suggest that informal enterprises account for a considerable share of total employment within the non-agricultural private sector<sup>14</sup>. Comparative data containing estimates or observations of this employment share is however hardly available. An exception is a study by Fox and Sohnesen (2012) on employment in 13 countries from Sub-Saharan Africa. They used the results of nationally representative household surveys to analyse the distribution of primary<sup>15</sup> employment across the following five employment sources: family farming, wage employment in agriculture, informal enterprises<sup>16</sup>, formal enterprises in the private sector and formal enterprises in the public sector. By far the largest source of employment in these countries is the agricultural sector, which accounts for 72% of the primary employment<sup>17</sup>. Informal enterprises are the second-largest provider, offering 15% of the total primary employment. Formal enterprises in the private sector (SMEs as well as large enterprises) account for 9% and public enterprises for 4%.

### Different levels of informality

In the discussion so far, enterprises are classified as either formal or informal, after which informal enterprises are treated as a single group. This suggests a certain homogeneity among these enterprises. And although this is certainly the case, there are also many differences that should not be overlooked. In many aspects, the group of informal enterprises shows a large heterogeneity (Grimm et al., 2012). For example, Levenson and Maloney (1998) argue that the informality of enterprises is determined by the extent to

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13 However, it should be noted that being registered at a statistical office is only one of several registrations that may be required for an enterprise. In Appendix 3 results from a National Baseline Survey in Trinidad and Tobago (Van Elk 1996) is shown were 21% of the enterprises are classified as informal, whereas the sample is taken from the register of the National Statistical Office. See also case studies 2 and 6.

14 Similar findings are reported by Ishengoma and Kappel (2006).

15 In case people have several sources of income, primary employment refers to their main source of income.

16 In Fox and Sohnesen (2012), the only criterion used to classify firms as informal is ownership: informal non-farm enterprises include all own-account (self-employed) enterprises working in the non-agricultural sector. Within this category, they use the size criterion to differentiate between household enterprises (enterprises without paid non-family workers) and micro enterprises (enterprises with at least one paid non-family worker). They find that within the population of informal enterprises, household enterprises account for more than 90% of all informal enterprises and more than 80% of all employment in informal enterprises.

17 This is a weighted average across all 13 countries.

which they decide to participate in societal institutions. This implies that formality can be defined as a continuum rather than a dichotomy, where the level of formality is determined by the number of societal institutions that an enterprise participates in. Other researchers distinguish different subcategories within the group of informal enterprises. Generally speaking, two subgroups can be distinguished (Ishengoma and Kappel, 2006, based on Djankov et al., 2002a):

- ▶ Subsistence enterprises; these include, for example, street traders, subsistence farmers and people working from their own homes. These enterprises typically operate at markets with low entry barriers and high product homogeneity, which results in high levels of competition.
- ▶ Unofficial enterprises; these include, for example, small manufacturers, service providers, distributors and contractors. As compared to subsistence enterprises, these enterprises can benefit from some product differentiation, and the owners generally have higher educational and skill levels<sup>18</sup>.

Compared to subsistence enterprises, unofficial enterprises have a higher level of resource endowment<sup>19</sup>. As a result, they may be more likely to formalize and compete successfully in the formal economy.

### 2.3 Why it matters: consequences of informality

Informal enterprises play an important role in many developing and emerging countries, if only because of their large number. Informal enterprises not only provide employment for many people, but also supply many products and services that are not offered by the formal economy (Ishengoma and Kappel, 2006). Nevertheless, there is little doubt that, across all developing and emerging countries, the informal economy needs to be reduced in favour of the formal economy. The transition from a large informal economy to a large formal economy can have positive effects on various levels.

First of all, formal enterprises tend to perform better than informal enterprises, in terms of survival rate, size and growth. Informal enterprises relatively often operate from a poor location (with less developed economic and physical infrastructure), with labour-intensive production methods and/or obsolete machinery, operated by employees with relatively low education and skill levels (Ishengoma and Kappel, 2006). At macro level, an increase in the number and/or size of formal enterprises translates into higher GDP levels and growth rates. This suggests that in countries where the formal economy is relatively large as compared to the informal economy, the levels of GDP per capita will also be higher. This is indeed the case (La Porta and Shleifer, 2008)<sup>20</sup>.

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18 Several studies provide a classification in three subcategories rather than two. Often, this resembles a further division of the category of unofficial enterprises into two separate categories (Ishengoma and Kappel, 2006). For example, the classification by Grimm et al. (2012) includes one category that resembles the subsistence enterprises (survival entrepreneurs) and two categories that combine into the unofficial enterprises (top performers and constrained gazelles).

19 This refers to the average level of human capital and the level of development of the technology utilised.

20 Notice, however, that the causality of this relationship may run both ways. This implies that if a country is faced with a reduction in GDP growth levels (or even a decline), this can lead to an increasing share of the informal economy.

Secondly, many employees will benefit from such a transition: formal employees tend to receive higher wages than informal employees (which is possible because labour productivity is higher)<sup>21</sup> and working conditions are better (and better protected) in formal enterprises as compared to informal enterprises.

Thirdly, an increase in the number of formal enterprises will increase a country's tax revenues, which in turn can be used for various public programmes<sup>22</sup>.

Finally, if a large share of the population is openly ignoring laws, regulations and taxes, this could have a negative effect of the attitudes of citizens regarding public institutions. A transition from an informal to a formal economy could improve the general attitude toward government, which would in turn have a positive effect on the intention to comply with regulations. De Mel et al. (2013) provide empirical support for this argument<sup>23</sup>. Based on an experiment conducted in Sri Lanka, they find a very strong effect of formalization on trust in local and provincial government, and conclude that the process of formalization may be a powerful tool for attitude change, by showing firm owners that their government can in fact be trusted.

These factors have the potential to reinforce each other. For example, a larger tax base allows for higher government investments in infrastructure, education and the rule of law. These investments, in turn, can improve the skills and competences of the workforce and improve productivity. Another example is that better working conditions improve the health status of employees. This can have a positive effect on their productivity, which in turn improves the performance of enterprises.

### **Making the transition from a large informal economy to a large formal economy**

So there are strong arguments in favour of applying well-designed policies to promote the transition from an informal economy to a formal economy. With respect to enterprises, this implies that policies are required that aim to decrease the number of informal enterprises and/or increase the number and/or size of formal enterprises. This includes policies that aim to stimulate informal enterprises to formalize themselves, but other policies are also possible (see section 2.5).

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21 Empirical studies confirm that workers in informal enterprises earn less than workers in formal enterprises. Also, workers in formal employment are more likely to have adequate earnings than workers in informal employment. There are some indications, however, that this difference between informal and formal employment is not due to the effect of informality but caused by an underlying difference in earnings between small and large enterprises (De Kok et al., 2013, par. 5.2).

22 The benefits of these public programmes will depend on the efficiency of the public sector, the level of corruption and other factors.

23 Their study is described in more detail in Chapter 9, as case study nr. 6.

## 2.4 Causes of informality

### Costs and benefits

What determines whether an enterprise will be (come) formal or informal? To answer this question, it is often assumed that individual firms make a conscious decision, based on a comparison of the expected costs and benefits of becoming and/or being formal.

The following costs of becoming and remaining formal are usually distinguished<sup>24</sup>:

- ▶ Entry costs; the time required to go through all of the required procedures to get registered and the licence or registration fees that have to be paid. The number of procedures and the level of efficiency of the offices involved vary from country to country<sup>25</sup>.
- ▶ Formal operating costs; the costs associated with operating in the formal economy:
  - Taxes, fees and social contributions.
  - Compliance costs; these include the costs of complying with labour regulations, the time required to obtain property registration and apply for formal loans, inefficient contract enforcement mechanisms etc.

Since the pioneering work of De Soto (1989), it is known that *entry costs* and *taxes, fees and contributions* can be very large in developing and emerging economies. Since then, many reforms took place around the world to reduce these costs (Bruhn and McKenzie, 2013b), but they can still be considerably large. Moreover, several studies show that informal enterprises often have an incorrect idea about the actual entry costs (De Mel et al., 2013). For policies that aim to stimulate informal firms to formalize, it may not be enough to reduce the entry costs; business owners must also be made aware of the actual costs involved.

The main benefits associated with being formal are:

- ▶ Reduced risk of fines, closure or bribes; although also formal firms run the risk of having to pay fines or bribes, this risk is much larger for informal firms. Because of their informality, these enterprises are at risk of having to pay fines (for not complying with all regulations), having to close their business (for the same reason), or of paying bribes (to prevent fines or closure). The extent of this benefit depends on the extent to which laws and regulations are enforced and/or on corruption by government officials.
- ▶ Easier to establish a permanent location; for informal firms it is not only relatively difficult to establish a permanent location (it is more difficult to find and use a suitable location for enterprises that are not registered) but also relatively risky (once informal enterprises establish themselves on a fixed location, it is nearly impossible to stay out of reach of government).

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<sup>24</sup> See e.g. Ishengoma and Kappel, 2006; Sakho, 2007; Zevallos, 2007; Ferraro and Gatto, 2010; Rojas, 2011.

<sup>25</sup> For a current overview of entry costs in most countries in the world, see "Doing Business 2014" by the World Bank and IFC (2013) that assesses regulations affecting domestic firms in 189 economies and ranks the economies in 10 areas of business regulation, amongst which 'starting a business', resolving insolvency and trading across borders. See also Table 3.3 in Section 3.3.

- ▶ Formal enterprises have better access to (public) business development services, to financial services and to insurance services. For example, public services tend to require that enterprises are registered and comply with regulations. Financial services and insurance services may require legalised transactions, which is difficult for informal enterprises. A better access to these services can improve the quality of their production factors (more and more recent capital goods, better trained owners and employees all contribute to improve productivity).
- ▶ Formal enterprises have access to more and different markets, such as products and services that are sold to other formal enterprises or to public organizations (which often limit their choice of suppliers to formal enterprises) and foreign markets (exporting is difficult for informal enterprises).

Combined, these benefits can increase the performance of individual enterprises in various aspects. For example, productivity levels can increase if enterprises decide to work from a permanent location<sup>26</sup> and can invest in new capital goods; and turnover levels (and employment levels) may increase if new markets are developed. These improvements in business performance are often seen as the main benefits of formalizing.

Regarding the *benefits of formalization*, the current discussion seems to focus on the question to which extent these benefits may apply to all (currently) informal enterprises. Some argue that in many aspects, informal firms are no different from other firms. In particular, they are just as motivated to develop and grow their enterprise as formal enterprises (of similar size) are and possess similar skills and competences. Others, however, very much doubt whether this is the case. This implies that many of the benefits associated with formalizing (e.g. access to external capital and to new markets) may only be relevant for a small share of all informal enterprises.

### How costs and benefits affect the decision to formalize: three views

Which of the various costs and benefits are the main causes of informality, and what does this imply regarding the consequences? Although this is still a topic of debate, three main views can be distinguished in the literature (Arias et al., 2010; La Porta and Shleifer, 2008, Bruhn and McKenzie, 2013b)<sup>27</sup>. These views differ in their evaluation of the main causes of informality, the characteristics of informal entrepreneurs and (consequently) on the best way to make the transition from a large informal economy to a large formal economy. In this section we will discuss these three main views:

- ▶ Exclusion view, also known as romantic view
- ▶ Exit view, also known as McKinsey view
- ▶ Dual economy view

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<sup>26</sup> Fajnzilber et al. (2011) show that productivity is higher for firms that operate from a permanent location, amongst others because it makes it easier to use capital goods in order to improve the efficiency of the production process.

<sup>27</sup> Other authors only distinguish the exclusion view and the exit view (Perry et al., 2007). It appears that the dual economy view is treated as a specific example of the exit view.

### The exclusion view

According to this view (based on the work of De Soto), the large share of informal enterprises can be explained by the high entry costs and the high levels of taxes, fees and/or contributions that are associated with becoming and/or remaining formal. The high levels of these costs effectively exclude these informal enterprises from the formal economy. If not for these costs, most informal firms would choose to formalize.

Underneath this explanation lies the assumption that in many aspects, informal firms do not differ much from formal firms of similar size. As far as their skill and competence levels, their motivation, and therefore their potential productivity are concerned, they are comparable.

This view is particularly optimistic about the potential of informal enterprises (which is why it is also known as the romantic view). It implies that many of them can potentially contribute to economic growth. All that is required is that the barriers they face in the formalization procedures are reduced or removed. Once these enterprises are formalized, they would gain access to external finance, external markets, etc., which would have positive economic effects, not only for the individual enterprise but also (given the large number of informal enterprises) for the economy as a whole.

The policy implications of this view are straightforward: a reduction of the high level of entry costs and of taxes, fees and social contributions would lead informal firms to switch into formality and potentially increase the overall productivity of the economy.

### The exit view

Proponents of the exit view assume that enterprises do not just consider the costs of formalization, but compare the costs with the benefits. This view is associated with the empirical studies by the McKinsey Global Institute, which is why some have labelled this the McKinsey view (La Porta and Shleifer, 2008).

The exit view leads to a more negative valuation of the existing informal enterprises. For informal enterprises, the benefits of formalizing are not large enough to compensate for the costs of formalizing. This implies that they are not productive enough to survive as formal enterprises. Only by evasion of taxes and social contributions, by avoiding rules regarding the quality of the product or service provided, and/or by evading regulations that aim to promote the quality of work for employees, can these enterprises compete with formal enterprise. Even worse, they can gain a considerable competitive advantage over formal firms. To avoid detection they remain small, thereby denying themselves the potential benefits of economies of scale and scope.

According to this view, the presence of informal firms has a negative effect on macro-economic growth, "both because their small scale makes them unproductive and because they take away market share from bigger, more productive formal competitors." (La Porta and Shleifer, 2008, page 277). In addition, because they drain fiscal resources, they contribute to a weak public infrastructure (Arias et al., 2010).

Rather than stimulating informal firms to formalize themselves, they should be forced to end their economic activities altogether, in order to make room for formal and more productive enterprises. An important policy implication of this view is therefore to increase law enforcement to eradicate informal firms. This would increase the market share of formal firms, and hence stimulate the growth of the formal economy<sup>28</sup>.

### The dual economy view

According to this view, the main explanation for the large number of informal enterprises is the lack of wage jobs in the formal economy.

Both the exclusion view and the exit view only consider two choices for entrepreneurs: being (or remaining) informal, or being (or becoming) a formal enterprise. They are concerned with choices regarding the organization of the enterprise, but not with the choice whether or not to be an entrepreneur. The third view explicitly includes the option of not being an entrepreneur, but being employee instead. According to this view, many people that currently run an informal enterprise would prefer having a formal wage job. Many people start a small, informal enterprise, not because they want to become entrepreneur, but because of a lack of suitable wage jobs and the absence of social security systems (Bruhn and McKenzie, 2013b; Ishengoma and Kappel, 2006). The large group of informal enterprises can be seen as “the disadvantaged segment of a dual labor market in which workers queue for good jobs” (Fajnzylber and Maloney, 2007, page 134), which is why this view is known as the dual economy view.

According to this view, the primary objective for many informal entrepreneurs is often just to obtain employment and income (rather than to aim for growth). Often, these entrepreneurs do not have the necessary skills (education) to become successful entrepreneurs. In combination with a lack of motivation to grow, this implies that the benefits of formalization will be very low for these entrepreneurs (Fajnzylber et al., 2011). It also implies that many informal firms will operate relatively inefficient, and cannot survive except when they are indirectly subsidized by avoiding the taxes and regulations of governments.

Whereas the exit view can be used to argue that informal firms actually harm the formal economy, the dual economy view implies that this is much less the case. The distance between the formal and informal economy is so large that informal firms are often not a serious threat to formal firms. Although informal enterprises do not pay taxes and social contributions, this should not be counted as a loss of public income, because a large number of these firms would not survive if they had to pay all taxes, fees and contributions. Meanwhile, informal firms provide subsistence to a vast number of people without any alternative means of income. At the same time, these firms are generally speaking not able to generate economic growth, irrespective of whether they would formalize or not.

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<sup>28</sup> Notice that according to this view, the transformation from a large informal economy to a large formal economy does not occur through the formalization of informal enterprises, but through the growth of already existing formal enterprises and/or the creation of new formal enterprises.

An important policy implication of this view is that policies stimulating informal enterprises to formalize often will not succeed. Many informal firms would not be able to compete in the formal economy, since they will hardly experience any benefits whilst their costs will increase. Informal firms operate inefficiently and cannot survive except when they are indirectly subsidized by avoiding the taxes and regulations of governments. According to this view, governments should not focus on formalizing the currently informal firms, but on stimulating the creation of new, formal firms and improving the conditions for the incumbent formal enterprises to stimulate employment growth. This requires policies improving the general business environment. This would increase the supply of wage jobs in the formal economy, thereby offering many subsistence entrepreneurs a better-paid alternative. Increasing the productivity of the overall economy will drive the remaining intrinsically unproductive informal enterprises out of business.

This does not imply, however, that policies to stimulate the formalization of informal enterprises will not be successful. In particular, both the exclusion view and the dual economy view are in support of policies to improve the conditions to start a new enterprise (where the exclusion view may also target existing informal enterprises, and the dual economy view may target start-ups).

## 2.5 Typology of formalization policies

### Different policies to stimulate the transition from a large informal economy to a large formal economy

At the end of the previous section, we already discussed the need for policies that aim to decrease the number of informal enterprises and/or increase the number and/or size of formal enterprises. Basically speaking, this can be obtained in four different ways:

- ▶ Informal enterprises (and especially unofficial enterprises that have the potential to become part of the formal economy) may be motivated to formalize by lowering the costs of becoming (and remaining) formal. This includes entry costs, taxes, fees and social contributions, and costs of compliance.
- ▶ Another way to motivate informal enterprises to formalize, is by improving the benefits of being formal. This can be obtained by reducing the bureaucracy and out-of-pocket expenses involved with obtaining a permanent location, getting access to business development services and new markets.
- ▶ The development of the formal economy may be stimulated by improving the general business environment. Amongst others, this implies that policies to lower costs and improve the benefits of formalization (as mentioned in the previous two bullets) should also target formal firms.
- ▶ Strengthening law enforcement.

The objective of this study is to learn more about policies that succeed in stimulating informal enterprises to formalize themselves. The latter two policy strategies (improving

the general business environment and strengthening law enforcement) will therefore not be discussed further.

### A typology of formalization policies

Many different policies have already been implemented throughout the world to support the formalization of informal enterprises. These policies can be classified in terms of their domain and the costs and benefits of formalization that are being targeted.

In 2011, the Donor Committee for Enterprise Development suggested a classification into nine different business environment domains (DCED, 2011):

1. Business registration and licensing; adapting business registration and licensing regimes to simplify the administrative processes of registration (for example, one stop-shop integrating all procedures necessary for business registration).
2. Simplification of taxation policy and administration, in order to ease tax compliance (for example, by introducing more transparent and simplified tax reporting, and differentiating tax schemes for micro enterprises, farmers and currently informal enterprises).
3. Land ownership and titling<sup>29</sup>; reforming incomplete cadastres and onerous or costly land registration systems and enabling female ownership of land and assets, in order to enable enterprises to work from a permanent location and to raise capital through land-based collateral.
4. Labour and labour-related issues; given the need for regulation to guarantee a proper functioning of the labour market, basic social protection for workers and skills development, the costs of complying with these regulations should be as low as possible.
5. Judicial reform; reducing transaction costs, improving the quality of governance methods and improving access to justice in bureaucratic administration.
6. Intellectual property rights; improving the enforcement of existing laws regarding trademarks and other property rights, in order to provide economic opportunities under legal operation.
7. Improved access to financial services; increase the access of poor women and men to the full range of financial services, in order to reduce the costs of raising capital.
8. Access to information about business regulation and rules; awareness (and understanding) of existing business regulations and rules is a prerequisite for enterprises to register.
9. Incentives for reform and communicating these to informal enterprises. Formalization should introduce the benefits of compliance with the legal and regulatory framework. Micro and small enterprises should see formalization as an opportunity for greater access to markets and growth.

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<sup>29</sup> Land titling is a form of land reform in which private individuals and families are given formal property rights for land which they have previously occupied informally or used on the basis of customary land tenure.

Government itself (being an important client in various markets for products and services) could be added as a tenth domain. For example, a percentage of public orders could be reserved for formal micro and small enterprises (MSEs), which could encourage informal MSEs to formalize (Ishengoma and Kappel, 2006).

Together, the various combinations of domain and targeted costs and benefits could be used to develop a detailed typology of policies to formalize informal enterprises. An initial version of such a typology is presented in Table 2.1, which may be used as a starting point for future discussions on this topic.

**Table 2.1**

Typology of formalization policies, by domain and the targeted costs and benefits of formalization.

Source: Panteia, 2014

		Targeted costs and benefits of formalization					
	Domain	Entry costs	Taxes, fees and social contributions	Compliance costs	Permanent location	Access to business development services	Access to new markets
1	Business registration and licensing	X	X			X	
2	Tax policy and administration		X	X			
3	Land ownership and titling	X			X		
4	Labour and labour-related issues		X	X			
5	Judicial reform			X			
6	Intellectual property rights						X
7	Improved access to financial services					X	
8	Access to information about business regulation and rules	X	X	X		X	
9	Incentives for reform and communicating these to informal enterprises	X	X	X		X	
10	Government as client						X

## 2.6 Empirical findings

A highly relevant question is then, whether some of these policy types are more successful than other types. Unfortunately, given our current state of knowledge on the effectiveness and efficiency of different policy types and in particular the lack of available studies that examine the outcome of specific policies using adequate econometrical methodologies, this question cannot yet be answered.

### When and how do enterprises decide between informal and formal?

A more fundamental question is whether policies to stimulate informal enterprise to formalize can be successful at all. This depends on *when* and *how* enterprises decide to be(come) formal or informal. Regarding the timing of the decision, some authors view the formalization of enterprises as a process, where the decision to formalize depends on the growth and age of the firm (Ishengoma and Kappel, 2006). Under these conditions, policies to stimulate informal enterprises to formalize may very well affect the outcome of the decision of existing informal enterprises. The outcomes of a few empirical studies suggest, however, that the majority of enterprises make this decision only once, at the start of the enterprise (La Porta and Shleifer, 2008; Fajnzylber et al., 2011). These results suggest that if the formalization of enterprises is indeed a process, the outcomes of this process hardly change over time.

The question *how* enterprises decide to be(come) formal or informal, is basically the question which of the three main views is the correct view. This is probably not the correct question; rather, it is which of these views applies to the largest share of the informal enterprises. One might argue that the exclusion view is especially relevant for describing and analysing the subpopulation of unofficial informal enterprises<sup>30</sup>, whereas the dual economy view seems to apply in particular for the subsistence enterprises:

- ▶ Unofficial enterprises have more potential (better resource endowment) and are therefore more likely to graduate / transform into a formal enterprise than subsistence enterprises are<sup>31</sup>. These enterprises have relatively much in common with formal (small) enterprises, which is one of the assumptions of the exclusion view.
- ▶ Subsistence enterprises operate less efficient than unofficial (let alone formal) enterprises. Especially for this group, the dual economy view seems most relevant.

The exit view may be equally relevant to both types of informal enterprises.

There are several indications that in particular the exclusion view does not seem to apply to a large share of informal enterprises. For example, based on an international empirical study, La Porta and Shleifer (2008) show that the entrepreneurs / managers of informal firms have lower educational levels than those of formal enterprises<sup>32</sup> and that informal

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30 As defined at the end of Section 2.2: within the population of informal enterprises, two subgroups can be distinguished: subsistence enterprises and unofficial enterprises.

31 See Ishengoma and Kappel (2006), who refer to Djankov et al. (2002a).

32 This can be related to the increase in the supply of unskilled labour in urban regions (which in turn is caused by a decreasing share of agriculture in employment, resulting in a huge rural-urban migration; Ishengoma and Kappel, 2006)

firms are less productive than formal firms (of similar size). This contradicts one of the main assumptions of the exclusion view. Based on these (and other) findings, they conclude that the dual economy view is the most appropriate view for the informal sector as a whole. Consistent with this are the results of a Mexican household survey, that show that the most often used argument of informal micro firms why they have not registered, is that they are too small to make it worthwhile (mentioned by 75% of the surveyed firms). Another indication is provided by an experiment described in De Mel et al. (2013)<sup>33</sup>, who find that a reduction of registration costs to zero does not have a significant effect on the decision of informal enterprises to formalize.

For a group of seven West-African countries, a recent study by Grimm et al. (2012) suggests that the share of unofficial enterprises<sup>34</sup> (within the population of informal enterprises) varies between 38% (Benin) and 68% (Ivory Coast). This would suggest a larger role for the exclusion view. These results are however strongly determined by the applied methodology<sup>35</sup>. In addition, their study does not include a comparison between (characteristics of) informal and formal firms. Consequently, these results should not be used to determine the relevancy of the three different views.

### What works?

In a recent review of empirical studies (Bruhn and McKenzie, 2013b), the outcomes of several policy evaluations are discussed<sup>36</sup>. Bruhn and McKenzie (2013b) mention that during the last decade most attention in the area of business regulation policy around the world went to policies making it easier to formally register a business. However in the opening section of their paper they already state that despite these reforms the majority of businesses in most developing countries remain informal. They define a business as formal if it is registered for the relevant municipal licences and with the tax department.

- ▶ Firstly they look into the extent to which business regulations are indeed barriers to firms becoming formal and whether lowering such barriers succeeded in bringing informal firms into the formal sector.
- ▶ Secondly they look into the extent to which being formal benefits these small enterprises.

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33 This experiment is included in Chapter 9 as case study 6.

34 Grimm et al. classify informal enterprises into three different categories: 'top-performers', 'constrained gazelles' and 'survivalists' (Grimm et al., 2012, Table 3). When combined, 'top-performers' and 'constrained gazelles' strongly resemble the category of 'unofficial enterprises'.

35 The group of 'top-performers' contains by definition 10% of all informal firms, and the group of 'constrained gazelles' is defined by comparing characteristics of all other informal firms to the top-performers. Hence, a different choice for the cut-of point of 10% would automatically result in a different share of both groups.

36 We only came across this study after we had completed the search for case studies as discussed in the next Chapter. Their study is similar to ours, both in terms of objective and outcomes. In particular, they also identified only a few empirically sound studies (two of them had also turned up in our literature search, i.e. Bruhn and McKenzie (2013a) on one stop shop in Minas Gerais Brazil (Case 4, Chapter 7) and De Mel et al (2013), an experiment carried out in Sri Lanka to reimburse registration costs (Case 6, Chapter 9)). In addition, they also found that the large majority of the cases they identified (7 out of 9) refer to Latin America, which is consistent with the results of our literature search.

Considering desired approaches such as 'randomised experimental approach'<sup>37</sup>, and a variety of non-experimental econometric designs, they describe nine cases<sup>38</sup>. These are listed in their Table 1, copied below as Table 2.2.

Their nine cases are classified in three classes, and the main conclusions can be summarised as follows:

1. The effect of business entry reforms on the number of firm registrations. One out of three studies shows an increase in business registrations by 5% because of opening one-stop-shops in six major cities in Mexico. But this could very well be new firm registrations.
1. Effect of business entry reform on formalization of informal firms. This class has the same focus as the present report and contains two cases. The first is again one-stop-shops in urban areas in Mexico showing that some informal business owners become wage workers due to the reform, some register their business, but these effects are small. The second case on municipal licensing reform in Peru finds that the reform increased the number of provisional licenses issued to informal firms, but many firms don't renew their license later on.
2. Effect of information, waived costs and enforcement on formalization of informal firms. In this category four cases are listed: (1) Peru: subsidized cost offer led to 10 to 12% of informal firms obtaining a municipal license; (2) Brazil: information and waived registration costs had no effect on formalization rate, municipal inspections increased formalization rate by 22 to 27 percentage points; (3) Sri Lanka: Information and cost reimbursement had no effect on formalization rate. This case is also described in this report in Chapter 9. The experiment also showed that if much higher amounts are paid – comparable to up to two months median profits of the enterprises concerned – a considerable effect on the number of registrations does occur (4) Delivering brochures with information to informal firms in Bangladesh had no effect on formalization rate.

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37 In order to avoid selection bias, one would randomly choose firms and make them formal and leave other similar firms informal and then compare the two groups.

38 They do not discuss how they identified these cases.

**Table 2.2:**

Summary of Studies on the Causal Effect of Policies to Promote Firm Formalization.

Source: Table 1 from Bruhn and McKenzie (2013b)

Study	Policy or program studied	Main results
<b>Panel A: Effect of business entry reforms on number of firm registrations</b>		
Bruhn (2011), Kaplan, Piedra, and Seira (2011)	One-stop-shop (combining municipal, state and federal business registration procedures) in urban areas in Mexico.	Reform increased business registrations about 5 per cent and also increased employment; Bruhn shows that the increase in registered businesses was mainly due to previous wage earners opening new businesses.
Bruhn and McKenzie (2013)	One-stop-shop in less populous municipalities in Minas Gerais, Brazil.	Program led to a reduction in number of firms registering during the first two months of implementation, with no subsequent increase.
Cárdenas and Rozo (2009)	One-stop-shop in six major cities in Mexico.	Reform increased business registrations by 5 per cent.
<b>Panel B: Effect of business entry reforms on formalization of informal firms</b>		
Bruhn (2013)	One-stop-shop in urban areas in Mexico.	Some informal business owners become wage workers due the reform, some register their business, but these effects are small
Mullainathan and Schnabl (2010)	Municipal licensing reform in Lima, Peru.	Reform increased number of provisional licenses issued to informal firms, but many firms don't renew their license later.
<b>Panel C: Effect of information, waived costs, and enforcement on formalization of informal firms</b>		
Alcázar et al. (2010)	Offer a subsidy for the cost of obtaining a municipal license to informal firms in Lima, Peru.	Subsidized cost offer led to 10 to 12 per cent of informal firms obtaining a municipal license.
Andrade et al. (2013)	Three interventions for informal firms in Belo Horizonte, Brazil	
(a) deliver brochures with information about registration process and potential benefits; (b) waive registration costs; (c) receive municipal inspector.		Information and waived registration costs had no effect on formalization rate; municipal inspections increased formalization rate by 22 to 27 percentage points.
de Mel et al. (2013)	Provide information and reimburse registration costs for informal firms in Sri Lanka.	
Giorgi and Rahman (2013)	Deliver brochures with information to informal firms in Bangladesh.	

Finally, a necessary condition for any policy to become a good practice, independent of its domain and the costs or benefits targeted, is that the policy must be implemented correctly and run by competent staff. In this respect, it has been suggested that government officials should “change their arrogant behaviour towards those in the informal sector .... Government officials may need to be sensitised to the importance of the informal sector” (Ishengoma and Kappel, 2006, page 24).

# 3 Available evidence on the impact of policies

## 3.1 Overview

Generally speaking, the best ways to determine causal effects of policies are to conduct randomized experiments or to apply non-experimental studies using advanced econometric methods (Bruhn and McKenzie, 2013b). Simply comparing informal and formal firms does not provide a good insight into causal relationships, such as the effects of a policy on the formalization of enterprises or the effect of formalization on various performance indicators, e.g. productivity, employment growth, and profitability of enterprises.

The main criterion for selecting case studies is that they provide credible evidence on the causal relationship between the set of policy/regulatory interventions and quantitative formalization indicators. We searched for studies that meet these criteria. First, we conducted a structured literature search (see Section 3.2 and Appendix 1). This resulted in 123 publications, of which relatively many concern reforms in Latin America.

In this chapter we will discuss the lack of quantitative evaluation studies that include microeconomic and macroeconomic effects of policies to encourage the formalization of informal MSEs.

We will present the results of our literature search (refer to Appendices 1 and 2 for a detailed description), and show that after a first assessment to which extent these papers complied with the selection criteria, only a limited number of relevant studies remained.

After discussing the literature search and the six cases finally selected in Section 3.2 and a brief overview in Section 3.3 of the business environment in the countries concerned, we will show why the number of cases finally selected is rather limited. As an illustration, a description of three cases is provided that were initially selected but proved not to satisfy the condition of being cases in which specific measures were studied resulting in credible quantitative evidence of the effect of these measures on formalization of enterprises:

- ▶ Section 3.4: The publication 'The impact of business environment reforms on new firm registration' by Klapper and Love (2010) provides useful insights but does not concern one specific case, it rather provides an overview and analyses various examples.
- ▶ Section 3.5 Case: Uganda, Jinja. After a more thorough assessment of this study it showed that it actually concerns the formalization of management of the market on which individual (informal) vendors operate and results of the study show that legalization of the organization did not provide the protection aimed at and the change was not appreciated by the informal vendors.
- ▶ Section 3.6 Case: Comprehensive strategy of the province of Mendoza, Argentina. This study presents a number of public policies and programmes aimed at fighting

informality which have been developed in Mendoza and it concludes with a synthesis of the main challenges for these policies. The study provides some quantitative data, however actual results on formalization, i.e. the number of entities that made the transition from informal to formal are not presented.

### **3.2 Literature search for selection of case**

The steps of the selection process to identify recent literature concerning credible empirical evidence on the effects of innovative policy/regulatory interventions encouraging formalization of Micro and Small Enterprises (MSEs) is briefly described in this section.

The literature review focussed on policy measures that intend to foster formalization of informal enterprises for example by increasing benefits of formalization, possibly by providing incentives and/or reducing costs and administrative burdens typically associated with formalization.

The intention has been to identify publications on effects of such policy/regulatory interventions on the number of firms moving from the informal to the formal sector. Hence the main criterion for selecting case studies has been the analysis of the causal relationship between the set or mix of policy/regulatory interventions and quantifiable formalization indicators.

Relevant steps that are described in more detail in Appendices 1 and 2 are:

1. definition of the terminology used and the scope of the exercise.
2. select relevant sources.
3. preliminary selection of literature from the selected sources.
4. final selection of relevant literature.
5. analysis of selected literature.
6. description of case studies.

Step 3 resulted in 123 English or Spanish papers, see Table A.2 in Appendix 1 for more details.

In Step 4 the researchers gave an overall score to the papers identified on a scale from 1 to 5 for suitability ranging from 1 (not) to 5 (very good). This resulted in 10 papers initially receiving a score of 4 or 5. As mentioned in Section 3.1, further analysis revealed that three papers did not qualify as a case in this report. So finally 7 of the papers selected were – in combination with some additional publications – used to describe 6 cases (see Table 3.1).

**Table 3.1:**  
Final selection of publications  
and resulting cases

Source: Panteia/IKEI

	Country	Authors	Title	Year	Case
1	Argentina	Guillermo Farías	'Monotributo, Informe final de consultoría' or 'Final consultancy report. Monotaxes'	2009	1
2	Brazil	Pablo Fajnzylber William F. Maloney Gabriel V. Montes-Rojas	Does formality improve micro-firm performance? Evidence from the Brazilian SIMPLES program	2011	2
3	Brazil	Ministerio de la Previsión Social, SPS – Secretaria de Políticas de Previsión Social	'Los desafíos de la Seguridad Social en Brasil en el contexto actual' or 'The challenges of Social Security in Brazil in the current context' ( cf. the Individual Micro-entrepreneur Programme)	2011	3
4	Brazil	Miriam Bruhn David McKenzie	Using Administrative Data to Evaluate Municipal Reforms; An Evaluation of the Impact of Minas Fácil Expresso	2013	4
5	Colombia	Stefano Farné Norma Baquero Claudia Álvarez	'La Ley 1429 de 2010 ha formalizado el empleo en Colombia?' or 'Has the 1429 Law of 2010 formalized employment in Colombia?'	2011	5
6	Colombia	Julián Domínguez Rivera et. al.	Impacto de la Formalización Empresarial en Colombia' or 'Impact of Business Formalization in Colombia'	2011	5
7	Sri Lanka	Suresh de Mel; David McKenzie; Christopher Woodruff	The demand for, and consequences of, formalization among informal firms in Sri Lanka	2013	6

After a thorough assessment finally the following cases are included in Chapters 4 to 9 of this report:

- ▶ Case study 1: Monotax (Argentina).
- ▶ Case study 2: SIMPLES (Brazil).
- ▶ Case study 3: Individual Micro-entrepreneur (Brazil).
- ▶ Case study 4: Municipal reforms (Brazil).
- ▶ Case study 5: Law 1429 (Colombia).
- ▶ Case study 6: An experiment in Sri Lanka.

### Classification of the 6 cases

The six cases finally selected are classified in Table 3.2 using two sets of criteria:

- ▶ To which of the nine policy fields<sup>39</sup> listed below do the measures studied belong:

1. bus registration & licensing.

<sup>39</sup> See: business environment domains as distinguished by DCED: Annex to the Practical Guidance on Supporting Business Environment Reforms: How Business Environment Reform Can Promote Formalization, DCED, 2011.

2. tax policy & administration.
  3. land ownership & titling.
  4. labour & labour related issues (maintaining workers protection while reducing administrative burden).
  5. judicial reform (e.g. access to dispute resolution channels).
  6. intellectual property rights.
  7. financial services (improve access to finance).
  8. access to information about business regulations & rules.
  9. incentives for reform and communicate this (access to markets and growth).
- Which of the 6 types of costs and benefits of formalization are targeted:
1. entry costs.
  2. taxes, fees and social contributions.
  3. compliance costs.
  4. permanent location.
  5. access to business development services.
  6. access to new markets.

**Table 3.2:**  
Classification of six cases selected

Source: Panteia

Cases	Policy fields DCED 1–9	Targeted costs and benefits
Monotax, Argentina	2	2, 3
SIMPLES, Brazil	2	2
Individual Micro-entrepreneur, Brazil	1 <sup>1</sup> , 2	1, 2
Municipal reforms, Brazil	12	1
Law 1429, Colombia	2, 4, 7	2, 5
Experiment Sri Lanka	13, 8	1

Notes:

1. The programme allows formalization of micro-entrepreneurs at low costs.
2. Set up one stop shop for business registration, especially extending this initiative to more remote areas outside main cities
3. Not making registration easier, but rather offering financial compensation to companies that would register

All cases included describe policies that aim to motivate informal enterprises to formalize, by reducing the costs of becoming formal (in addition, Law 1429 also aims to improve the benefits, a.o. by improving access to business development services). This is in line with the main recommendations that are associated with the exclusive or romantic view (see three views described in Chapter 2). When we consider the implementation of these policies (rather than the motivation), it becomes clear that they are not

restricted to informal enterprises, but that they apply to all enterprises, as well as to new start-ups. Except for the experiment in Sri Lanka, this is the case for all case studies. Consequently, the implementation of these policies is also consistent with the dual economy view. The relevance of this distinction is illustrated by one of the main findings of case 2 (SIMPLES, Brazil): the SIMPLES programme has had a positive effect on start-ups to register directly at the time of start-up. This, in turn, had a positive effect on the decision of these start-ups to work from a fixed location, which in turn had positive effects on the scale and arguably, technology of production (Fajnzylber et al., 2011).

### 3.3 A brief overview of the business environment in the countries in which the selected cases are located

**Table 3.3:**  
Cost of doing business in countries from which cases are selected

Source: IFC/World Bank "<http://www.doingbusiness.org/rankings>"; consulted on 17-4-2013.

In paragraph 2.6 the effect of (changes in) the business environment on the creation of new formal or informal enterprises was already discussed. The Cost of Doing Business data of the World Bank provide a picture of this for many countries in the world. Table 3.3 shows the relative position of the four countries in which the selected cases in this report are located on the list of 189 countries around the world. The aim is to give the

Country	Ease of doing business rank	Starting a business	Dealing with construction permits	Getting electricity	Registering property	Getting credit	Protecting investors	Paying taxes	Trading across borders	Enforcing contracts	Resolving insolvency
<b>Top-5 of the world</b>											
Singapore	1	3	3	6	28	3	2	5	1	12	4
Hong Kong SAR, China	2	5	1	5	89	3	3	4	2	9	19
New Zealand	3	1	12	45	2	3	1	23	21	18	12
United States	4	20	34	13	25	3	6	64	22	11	17
Denmark	5	40	8	18	7	28	34	12	8	32	10
<b>Four countries from which cases are selected</b>											
Colombia	43	79	24	101	53	73	6	104	94	155	25
Sri Lanka	85	54	108	91	145	73	52	171	51	135	59
Argentina	126	164	181	80	138	73	98	153	129	57	97
Brazil	116	123	130	14	107	109	80	159	124	121	135
<b>Bottom 5 of the world</b>											
Congo, Rep.	185	182	142	175	164	109	157	183	180	164	142
South Sudan	186	140	171	184	183	180	182	92	187	87	189
Libya	187	171	189	68	189	186	187	116	143	150	189
Central African Republic	188	177	156	177	141	109	138	188	185	180	189
Chad	189	183	139	149	146	130	157	189	183	171	189

reader a general idea of the framework conditions when reading the cases presented in Chapters 4 to 9.

Economies are ranked according to their ease of doing business, from 1–189. A high ranking on the ease of doing business index means the regulatory environment is more conducive to starting and operating a local firm. This index averages the country's percentile rankings on 10 topics, made up of a variety of indicators, giving equal weight to each topic. The rankings for all economies are benchmarked to June 2013.

### **3.4 Impact of business environment reforms on firm registration**

As mentioned in Section 3.1 we present a description of this publication to illustrate why the final selection of cases only contains 6 cases. 'The impact of business environment reforms on new firm registration' by Klapper and Love (2010) provides useful insights but does not concern one specific policy measure with credible evidence for its results. It rather provides an overview and analyses various examples. So it does not satisfy the conditions for cases as presented in Chapters 4 up to 9.

#### **General overview**

This study investigates the relation between the "ease of registering" a business and actual regulations. In addition it studies the magnitude of reform in entry regulations required to achieve a significant impact on firm registration numbers. The study shows that in general the costs, the number of days and the number of procedures required to register an enterprise are important predictors. It also shows that smaller reforms do not have a significant impact on the number of newly registered firms. Reforms combining multiple indicators have a larger impact, and simultaneous reforms are found to have more effect than sequential reforms. Finally, the initial conditions also matter; reforms have more effect in countries with better pre-existing conditions for registering a business.

#### **Problem definition**

The rationale behind regulatory responses in the area of business registration or formalization is generally based on the findings in the research literature that (formal) entrepreneurship can foster competition and economic growth. Facilitating and encouraging formal business entry or registration is often directly related to economic growth.

The creation rate of new firms is assumed to be related to country-level indicators of economic development and growth, the quality of the legal and regulatory environment, ease of access to finance, and prevalence of informality. Here, the study looks particularly at the registration process, and how reforms in this process may lead to more registrations.

#### **Regulatory response**

The study assumes that there are benefits related to business registration. These benefits may a.o. be (1) increased access to finance, (2) sales tax ID to attract larger and/or foreign

customers, (3) better contract terms with suppliers, or (4) a reduced risk of governmental sanctions.

Registration costs are considered to consist of (non-)official payments, time spent on procedures and for instance capital requirements. Tax payments (that are due once registered) should also be considered costs, but are excluded from this study for practical reasons.

Another assumption of the study is that reforms target the costs of registration, and that a reform is able to reduce the costs of business registration. Moreover, the choice to formally register a company is assumed to be an economic rational decision, i.e. benefits outweighing costs. The model used for the study assumes that the benefits will remain the same, and are based on the average benefits for all firms. This relatively broad operationalization of “regulatory response” allows an analysis across 92 countries, based on the “World Bank Doing Business” dataset on new business environment, combined with the World Bank Entrepreneurial Snapshots database on the registration of companies with limited liability.

The World Bank Doing Business dataset includes variables on business environment factors that the Klapper and Love study associates with registration costs; (1) starting costs, in terms of required fees, (2) number of procedures, (3) required starting days, and (4) minimum capital requirements for companies that want to register. For the entire dataset the mean of the annual per cent change is negative, which shows that most countries are successfully working on lowering the costs related to registration.

## Implementation

As explained above, the study defines a reform as a reduction of registration costs, which may be either a reduction of registration fees, of the number of procedures, of the time required for registration, or of capital requirements.

## Results/Outcome

As a first test, Klapper and Love checked whether the hypothesised negative relation between registration costs and business registration is indeed confirmed in the data, which is the case, also when controlling for GDP and the year to circle out common trends.

A further distinction was made between single reforms in a country and the effect when several reforms are implemented simultaneously or sequentially. For single reforms, reduction of payment has to be at least 50% to have a significant effect on the number of registered businesses. The required reforms for reducing the length of the procedure is much smaller, a reduction of 15% already leads to a significant change, and the optimum is found between 20%–40%. For capital requirements a weaker effect on business registration was found, presumably because this requirement does not exist in some countries. Still, reduction of 40–50% has a significant impact on business registration.

When looking at several reforms combined (for instance reducing the length and payments of registration together), the study finds evidence for the intuitive assertion that less drastic reductions are required for individual reform when two reforms are combined, because of the supposed synergistic effect. A slightly stronger effect was found for reforms that were combined in the same year, as compared to sequential reforms. This is even further confirmed when combining 3 reforms; even less drastic reduction of the individual components is required, due to synergy.

In conclusion, the research team points to the caveat of their study that combined measures reducing costs involved with registration may be part of a broader reform package that seeks to improve the general business environment, rather than just business registration. As such, the increase in business registration may be partially unrelated to the registration costs. However, even in such circumstances, they assert, the results suggest that small changes in the registration parameters (less than 30%) are unlikely to increase formal sector participation.

In addition to these general findings, the study also sought to control for pre-reform levels of the business environment. So, Klapper and Love constructed an aggregated measure for the level of business environment, based on the score on the 4 individual components of costs associated with registration. They found that countries with weaker pre-existing business environment levels need a larger reform to achieve the same impact on the number of registered businesses than a country with higher scores on pre-reform business environment. Also when reforms are combined into simultaneous or sequential reforms, the pre-reform business environment level influences the required magnitude for increasing business registration.

### Lessons learnt

Based on the findings of the study, the conclusion can be drawn that the '*ease of starting a business*' has a significant impact on business registration. Small reforms however that only marginally improve the requirements for business registration do not have an effect. Generally, around 40% of reduction in costs, days or number of procedures is required in order to have a significant positive effect on the number of business registrations.

It is also shown that countries with weaker business environments require significantly larger reforms in order to influence business registration. It is suggested that this may be the case due the fact that such countries also have fewer benefits for formal sector registration; as such, larger reductions of costs are therefore necessary to become lower than the benefits.

### 3.5 Uganda: Jinja case study

As mentioned in Section 3.1 we present this case to illustrate why the final selection of cases only contains 6 cases. The case of the Jinja market in Uganda emerged from the literature search with keywords, but after a more thorough assessment it showed that it actually concerns the formalization of management of the market on which individual (informal) vendors operate and not formalization of the traders themselves. So it does not satisfy the conditions for cases as presented in Chapters 4 up to 9.

## General overview

The article by Lince (2011) discusses two policies introduced in Jinja, Uganda targeted at local vendors and fishers. The 'open-air market formalization scheme' and the '2004 national fisheries policy' both encouraged informal firm owners to formalize by pointing at advantages such as increased prosperity for the vendors / fishers by increasing participation in the formal economy and representation in local governance. However, according to this study, these policies did not solve problems of poverty and underdevelopment, and had unintended negative consequences for the economic actors involved. Formalization offers new forms of democratic representation, but at the same time takes away direct control of the vendors / fishers on their own livelihoods, their bargaining and earning power and informal strategies for maintaining financial stability and security. Furthermore, the representation offered is weak and does not protect vendors and fishers to the required extent. Lince (2011) concludes that as long as the Jinja informal sector offers greater security, bargaining power and control over productive resources for vendors and fishers, formalization (and the associated participation in local decision-making) is not an attractive option.

## Problem definition

Self-organised strategies of vendors and fishers that developed in Jinja – Uganda can be considered as tools for resisting governmentality, both in colonial times and currently, but are often more practical ways in which people find viable livelihoods for themselves under more uncertain political times. Both small-scale fishers and vendors are often considered to have chaotic or unruly behaviour, formalization strategies have not taken the practical organization strategies into account.

## Regulatory response

Two particular responses are discussed in the research paper: the Market Formalization Scheme and the national fisheries policy. Here, only the market formalization scheme is discussed.

Under the Market Formalization Scheme the government tries to improve efficiency in service provision and create conditions for participatory government. The idea is that vendors who were previously working in unpermitted and unregulated sectors enter into a legitimate relationship with formal governments, which would give them greater access to legal and political protection. Even though it provides a way of representation in local issues for the vendor, it in fact undermines their bargaining power and increases uncertainty about market governance.

Another big change with formalization is that the individual vendor is now made responsible for delivering taxes and dues to (local) government, whereas before, in informal markets the *collective* cooperated and protected each other against certain risks (fines, seasonal productivity) by collective overpricing. The formalization scheme changed this collective protection into a more individualised one.

The study is based on the example of the “Amber Court market” in Jinja – Uganda. This market used to be informal in the beginning and had grown from a small group of women selling basic necessities by the roadside to a busy market governed by an unregistered but highly organised vendors’ association. This association, led by an elected chairperson managed vendors’ collective investments in market improvements. Fees were collected by this organization for maintenance and improvement of the market and could relatively easily be changed in reaction to local or global fluctuations in revenues. This flexible system protected vendors against unexpected changes and served as a collective safety mechanism.

In 2005 the government started to award formal contracts to manage the market, for which there was little attention other than the vendors’ association itself. After two years however, the local authorities started to award the contract to a private businessman who did not have any connection to the market. This was also due to the fact that local vendors could no longer bid for the contract as the new criteria for contract awards now required bidders to have business education and access to credit. Even though the contract specifies how much the manager will have to pay for the contract, responsibilities are much less clear. Fines / fees were raised, whereas it seemed much less clear what the entrepreneur did in terms of maintenance or improvement of the market. Many vendors started to complain about the situation, and in effect had little influence left on how the market was run. Compared to the previous (informal) situation, where they could vote for the management of the vendor association they now had little influence. The change to formal private management had turned the self-employed vendors into employee-like workers without much bargaining power.

### **Results achieved**

Based on the case study of the Amber Court market, the study concludes that formalization of management and legalization of the organization does not necessarily provide the protection afforded by invisibility or informal strategies. For the Amber Court market greater visibility did not increase political participation and in fact increased confusion about jurisdiction and authority. At the same time, in order to receive this ‘political participation’ vendors were required to give away their control over their self-determination.

### **3.6 Argentina: Case comprehensive strategy of Mendoza**

As mentioned in Section 3.1 we present this case to illustrate why the final selection of cases only contains 6 cases. This case study focuses on the province of Mendoza in Argentina. The study presents a number of public policies and programmes aimed at fighting informality. The study provides quantitative data, for example on the number of jobs created, the number of enterprises benefitting from incubator centres and the amount of subsidies allocated to enterprises. However actual results on formalization, i.e. the number of entities that made the transition from informal to formal are not presented. So it does not satisfy the conditions for cases as presented in Chapters 4 up to 9.

## General overview

This case study presents a comprehensive strategy applied in the province of Mendoza (Argentina) with the objective of fighting informality. In this case different public policies and programmes are considered that are aimed at the same general purpose. The case study is based on *"Informality in the province of Mendoza. Policies to promote the formalization and characteristics"* published in 2011 by the ILO and the Ministry of Production, Technology and Innovation of the Government of Mendoza (Bertranou et al. 2011). This report is based on two main sources of information:

- ▶ The module of informality published with the permanent household survey and the survey of living conditions conducted in Mendoza in the fourth quarter of 2009 by the Directorate of Statistics and Economic Research of the Ministry of Mendoza.
- ▶ Information on policies and programmes developed at national, provincial and municipal levels, which directly or indirectly influence the possibility of formalizing enterprises and employment.

## Problem definition

Informal economy is defined as the *"production units and workers who carry out their activity aside from the legal framework that regulates the relations between economic actors"*. Production units are considered to be "informal" when they do not comply with all tax, accounting and labour standards. In particular, informal production units have the following characteristics:

- ▶ small-scale businesses.
- ▶ low legal visibility.
- ▶ weak economic inclusion, due to limited commercial relations with formal businesses and institutions.
- ▶ restrictions to access the legal framework which ensures the fulfilment of contracts.
- ▶ almost no access to the financial system and limitations to face the costs derived from formalizing operations, mainly due to low levels of productivity and profitability.

Additionally, the report explains that work within the informal economy is correlated with educational variables and with access to capital: the higher the education level and the easier the access to financial funds, the lower the probability of working as an informal business owner. Also, private and public services show a lower incidence of informality than the industrial sector.

## Regulatory response

The sections A and B show the most significant measures applied in the province of Mendoza which facilitate business formalization.

## **A. Policies and programmes aimed at production units.**

These actions aim to increase competitiveness among businesses by simplifying formalization procedures, as well as promoting employment formalization. In the province of Mendoza, the problems of informality are closely related to the productivity levels and the levels of profitability of production units, which partly limit the capacity to face formal labour and tax costs. The provincial government seeks to improve competitiveness which should have a positive impact on encouraging more enterprises to participate in formal activities.

The policies aimed at production units include:

- ▶ tax incentives, e.g. for technological and R&D activities.
- ▶ improvement of the business climate; e.g. reduce administrative burden, introduce one stop shop.
- ▶ improvement of the access to financial funds.
- ▶ promotion of associationism and cooperativism (associationism is a tool that allows entrepreneurs and producers to enhance their individual skills and evolve towards organizations with more capabilities).
- ▶ public-private cooperation to allow making more efficient use of public sector tools such as the Institute of Industrial, Technological and Services Development (IDITS).
- ▶ recognition of labour relations and reduction of workers' formalization costs.
- ▶ promotion of labour rights.
- ▶ implementation of an effective strategy for labour inspections.

## **B. Activities for the promotion and social protection of disadvantaged social groups.**

These programmes seek to improve employability and increase self-employment and social protection among the working population and the unemployed, e.g.:

- ▶ training policies and programmes, for completing basic formal education, vocational training and work-based learning.
- ▶ promotion of self-employment.
- ▶ job placement services.
- ▶ social investment and improvement of working conditions.

Important is a comprehensive approach to the promotion of formal self-employment by improving access to capital and technology and by providing training and technical assistance.

## Results achieved

The policies and programmes developed have probably led to direct or indirect impacts on formalization among businesses and workers, however as policies do not have a proper monitoring and evaluation system limited information on impact and effectiveness is available.

The following lines show some data concerning the level of activity of a number of relevant programmes and actions to reduce informality in Mendoza:

## Lessons learnt and conclusions

Main findings:

- ▶ In most cases, informality is related to subsistence needs.
- ▶ Activities with low productivity levels generate vulnerable employment.
- ▶ Among self-employed workers, high educational levels and access to capital reduce the probability of becoming informal.
- ▶ Reducing informality requires comprehensive and multidimensional policies concerning a.o. labour training, access to capital, technical assistance for entrepreneurs, as well as strategies to promote economic growth and sustainable development of formal enterprises.
- ▶ The coordination between national policies and institutions and provincial and municipal actions should be improved and objectives be lined up.
- ▶ There is a need to develop concrete follow-up, monitoring and evaluation schemes.

The most appropriate measures were found to be:

- ▶ financing for micro-enterprises from the Fund for the Transformation and Growth.
- ▶ the Provincial Programme of Business Incubators.
- ▶ the Social Entrepreneurs Programme.
- ▶ the Programme for Recovered Enterprises.
- ▶ centres for work training.
- ▶ training and employment insurance.

## 4 Case study 1: Monotax (Argentina)

### 4.1 General overview

This case study focuses on the simplified regime for small taxpayers, known as monotax (or “Monotributo” in Spanish), created in the Republic of Argentina in the year 1998 with the passing of the Law 24.977, approved on the 3rd of June of 1998.

According to the DCED informality policy fields, the Monotax regime falls into the ‘taxation policy and administration’ category. The regime basically consists of a single tax with a flat monthly fee, which in a single payment replaces the Income Tax and the Added Value Tax; additionally, it also includes Social Security and Social Work contributions.

The Monotax seeks a reduction in the burden that the payment of indirect taxes means for taxpayers, by facilitating the fulfilment of tax obligations. Moreover, it also seeks to increase the resources collected by the Tax Administration.

This case study is based on the reports published by the Federal Administration of Public Revenue in Argentina in 2006 about the simplified regime for small taxpayers, as well as on a consultancy report about the Monotax published in 2009, by Guillermo Farías.

### 4.2 Problem definition

In Argentina, small enterprises cover a significant part of all salaried employment. More specifically, in 2011, 19% of the total employment was in enterprises of up to 5 people, and another 19% in companies of 6 to 25 workers. These small enterprises and small taxpayers have particular characteristics, which make it necessary to provide them with a differentiated treatment:

- ▶ Small taxpayers constitute a large number of taxpayers who contribute a very small part of the total fundraising.
- ▶ They have a low level of organization.
- ▶ They tend to operate in the informal economy.
- ▶ It is difficult to impose rigorous formal obligations.
- ▶ They have little professional assessment on the payment of taxes.

Before the new regime was established, small taxpayers paid the Income Tax and Social Security contributions under the General Regime, in compliance with all formal requirements. And with regard to the value added tax, taxpayers whose income was lower than USD 24 854 per year were able to choose to declare themselves as “not enrolled”. This meant that they did not have to submit tax declarations, and they had to pay a surcharge of 50% over the VAT rate on their purchases.

This context led to a significant part of the productive units to fall into the so-called “in-voluntary informality”, which had to do with the tax system itself, its complexity and the high cost associated with the completion of the formalities (indirect taxation).

In 1998, the Federal Administration of Public Revenue and the legislators of Argentina suggested the creation of a simplified system for small taxpayers.

This system has the following objectives:

- ▶ Fight informality and evasion.
- ▶ Give small enterprises the possibility of moving to “formality” through the payment of an affordable tax amount.
- ▶ Facilitate formalization via the access to bank credits, and offer retirement benefits and health coverage through social security contributions.

### 4.3 Regulatory response

The simplified regime for small taxpayers, known as Monotax, was created in 1998 with the Law 24.977. This Law was passed in order to:

- ▶ Optimize the resources of the Public Revenue Administration.
- ▶ Promote the incorporation into the system of taxpayers operating in the informal economy.
- ▶ Reduce the administrative burden and the cost of compliance with tax obligations (the idea was to reduce the informality caused by the previous tax regime, as it was too complex and costly).

The regime has two components: one of them is the integrated tax (VAT plus the income tax) and the other one includes social security contributions (for retirement and health).

Since its implementation, the simplified regime has undergone several modifications. The first one was carried out with the Law No. 25.239, in force from April 2000; the second one with the Law No. 25.865, effective from July 2004; and the third one with the Law No. 26.565 of November 2009, which entered into force in January 2010. Changes in legislation refer mainly to modifications in taxpayers' categories and in income levels.

### 4.4 Implementation of reform

The simplified regime for small taxpayers, Monotax, regulated by the Law 24.977 and its later modifications, is characterised by the following main features:

#### a. The small taxpayer definition:

“Small taxpayers” are individuals who sell goods, carry out works, leases and services, or are members of work cooperatives and irregular societies of up to three members. The Law explicitly excludes:

Members of types of companies not included (Public Limited Company, Limited Liability Company, Collective Society, etc.) and the included which are not attached.

People who carry out more than three simultaneous activities, or have more than three units of exploitation.

## **b. Requirements to join and continue in the Monotax scheme:**

- ▶ The gross income obtained in the previous year should not exceed the limits established by the Law: USD 34 520 annually and USDD 51 780 for the sale of goods.
- ▶ If the taxpayer sells chattel<sup>40</sup>, these items not have a price higher USD 432
- ▶ The taxpayer is not allowed to be an importer of chattel and/or services.

## **c. Features of the simplified regime**

- ▶ Small taxpayers may have employees (there is no limit on the number of employees), and they are obliged to submit monthly statements and payments according to the general scheme of employers.
- ▶ They must issue the so-called bills of type "C" determined by the Federal Administration of Public Revenue, and they cannot differentiate the VAT in the invoices issued.
- ▶ They must display proof of registration in the simplified regime and proof of payment of the last fee.

## **d. Categorization and amount to be paid**

- ▶ Categorization: the taxpayer himself has to perform a self-categorization every 4 months, subject to the timely verification by the entity in charge.
- ▶ The amount of the monthly payment is determined taking into account the gross income: turnover, the area of land used by the business and the level of electrical energy consumed, see Table 4.1. The highest category indicated by one of the three criteria is used to determine the amounts to be paid.
- ▶ The other component that integrates the monthly fee refers to social security contributions, which are fixed amounts for all categories, including contributions to the pension scheme and social works.

## **e. Fundraising target**

- ▶ 70% of the income collection corresponding to the integrated tax (Income Tax and Value Added Tax) is for the ANSES (National Administration of Social Security), whereas 30% is set aside for provincial jurisdictions according to the partnership's tax regime.

The Law N°26 565 of November 2009, which entered into force in January 2010, widened the capacities of the Federal Administration of Public Revenue:

- ▶ Regulate retroactive un-subscription or renounces.
- ▶ Establish payment systems for seasonal activities.
- ▶ Modify once a year the maximum turnover limits, rentals accrued and the amounts of the integrated tax and social contributions.

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<sup>40</sup> any article of tangible property other than land, buildings, and other things annexed to land.

Category	Annual gross income (USD)	Activity area affected	Electrical energy consumed annually	Number of workers	Monthly Tax USD		Pension Contribution USD	Social Contribution (*) USD	Total to pay USD	
					Leases or services	Furniture and other sales			Leases or services Furniture and other sales	Furniture and other sales
B	4 142	30 m2	3 300 kw	0	7	7	19	120	38	38
C	6 214	45 m2	5 000 kw	0	13	13	19	120	44	44
D	8 285	60 m2	6 700 kw	0	22	20	19	120	53	51
E	12 427	85 m2	10 000 kw	0	36	33	19	120	67	64
F	16 570	110 m2	13 000 kw	0	69	53	19	120	100	84
G	20 712	150 m2	16 500 kw	0	95	70	19	120	126	101
H	20 854	200 m2	20 000 kw	0	120	87	19	120	151	118
I	30 560	200 m2	20 000 kw	0	275	213	19	120	306	244
J*	40 561	200 m2	20 000 kw	1	--	344	19	120	--	375
K*	46 602	200 m2	20 000 kw	2	--	404	19	120	--	435
L*	51 780	200 m2	20 000 kw	3	--	464	19	120	--	495

(\*) Only applicable for sale offers.

(\*\*) The category A has been deleted.

**Table 4.1:**

Tax for sales activities, locations, services and other activities, 2010–2012

## 4.5 Results achieved

The Monotax was created for promoting the registration and the formalization of small contributors who were outside all formal registrations. Since its creation the volume of registered taxpayers has continuously increased. According to 2009 data, 2 019 095 taxpayers were registered in the General Simplified Regime, with a total revenue of USD 7.1 million.

The number of active taxpayers reflects a growing trend since the creation of the regime. Between 1998 and 2009, the amount of active taxpayers increased from 642 167 to approximately 2 020 000.

Despite the high volume of taxpayers registered in the Monotax simplified regime, the tax collection (tax and social security components) represented only 0.88% of the Federal Administration of Public Revenue in September 2009. Thus, the simplified tax regime has a relatively small financial impact.

In 2009, 45.2% of the total number of the registered taxpayers of the Monotax (that is, 913 120 taxpayers) refers to the taxpayers registered in lease activities and/or services, located in the lower categories (categories A and B, see Table 4.2).

**Table 4.2:**

Monotax payers registered in January 2009 according to activity and category

<b>Leases or services</b>		
Category	Number	%
A	553 394	27.4%
B	359 726	17.8%
C	185 126	9.2%
D	110 261	5.5%
E	150 200	7.4%
<b>Subtotal</b>	<b>1 358 707</b>	<b>67.3%</b>
<b>Other activities</b>		
F	152 524	7.6%
F – Primary Activity	42 267	2.1%
G	130 773	6.5%
H	73 741	3.7%
I	43 393	2.1%
J	41 064	2.0%
K	19 712	1.0%
L	12 123	0.6%
M	11 145	0.6%
<b>Subtotal</b>	<b>526 742</b>	<b>26.1%</b>
<b>Eventual</b>	<b>133 646</b>	<b>6.6%</b>
<b>Total</b>	<b>2 019 095</b>	<b>100.0%</b>

In 2008, the number of payments was only equal to 72% of the numbers of registered taxpayers. There is no specific and definite explanation for this gap, but two reasons might explain this: (i) registered taxpayers have stopped their business activities but have not communicated this to the public authorities, so they are still registered as taxpayers; (ii) people have registered their new business, but the start-up did not materialized. In other words, there were more taxpayers registered than the number of people with active businesses that really could be taxed. This gap decreased between 1998 and 2002, but from 2003 to 2008 it started to grow.

After the reclassifications to be performed every 4 months, the details of the evolution in the period 2005–2009 show that in 83% of the cases changes are made towards higher categories, in comparison to 13% of the cases, which changed to lower levels.

According to the report published in 2006 by the Federal Administration of Public Revenue about the simplified regime for small taxpayers, there was no fiscal cost, since the losses in the Income Tax, the Value Added Tax and the Self-Employment fees have been compensated with the tax collection of the Monotax regime.

- ▶ Only 2.5% of those enrolled under the VAT regime joined the Monotax, and their payments were just 0.1% of the collection of the tax. 61.1% of them had not made any payment in that year.
- ▶ Concerning the Income Tax, 11.4% of the participants joined the Monotax simplified regime, whereas their participation in the collection of the tax was only 0.8%. It is noticeable that that 83.8% of the contributors enrolled in the Income Tax who joined the Monotax simplified regime had not made any payment in that year.

#### 4.6 Lessons learnt and conclusions

The Monotax offers the following advantages to tax contributors:

- ▶ Within the categories defined: their sales do not generate VAT tax obligations; income gains do not generate tax obligations either.
- ▶ They do not have to pay for VAT and income tax.
- ▶ They do not have to submit a sworn declaration concerning VAT and income taxes
- ▶ They do not need to keep accounting records.
- ▶ Reduction of self-employment fees.
- ▶ The regime covers the inclusion of the health insurance system.

The following conclusions can be drawn on the Monotax simplified regime:

- ▶ The scheme has a great ability to incorporate businesses into the formal system that, by their size and characteristics, have a high propensity to informality.
- ▶ The implementation of this new scheme in the year 1998 meant a change in the configuration of the tax system as a consequence of the segmentation of taxpayers, and it involved a simplification of the tax system for small businesses.
- ▶ The system turned to be inclusive since it allowed the incorporation into the formal economy of contributors, providing them with health coverage and pension protection.
- ▶ The implementation of the regime was successful both in terms of registrations and tax costs.
- ▶ The simplified regime has replaced the obligations of the general scheme of VAT and the Income Tax and has incorporated into Social Security coverage a very large volume of small taxpayers.
- ▶ The difference between actual payments and registered tends to increase, which shows a propensity for late payment among tax contributors.
- ▶ After reclassifications, most taxpayers were re-categorised to a superior category; however the classification by gross income did not show significant modifications.

And finally, it is interesting to detail some weaknesses detected in the Monotax system of Argentina:

- ▶ It is probable that some taxpayers may have declared a lower gross income than their real one, in order to join the Monotax scheme and evade the VAT and the Income tax.
- ▶ Sometimes the Monotax is used for registering workers that actually should be registered as employees under a labour dependency relationship (in other words, employers make their employees register as if they were self-employed under the Monotax system)
- ▶ Monotax payers from all categories contribute the same amount for retirement, regardless their characteristics. The consequence is that all of them obtain the minimum retirement, equal to the self-employed.
- ▶ There are difficulties for controlling the self-categorization in the initial registration and the later re-categorizations. The breadth of the universe of taxpayers complicates the verification of self-categorizations. And thus the control by the Revenue Administration turns to be costly in comparison to the benefits derived from it.

As a whole, the Revenue Administration must avoid all these weaknesses, and promote the voluntary fulfilment of tax requisites and create tax awareness amongst contributors. For this reason, Law 2009 widens the power and capacities of the Federal Revenue Administration.

## 5 Case study 2: SIMPLES (Brazil)

### 5.1 General overview

It is a well-known fact that the size distribution of enterprises is much skewed. This skewness is also apparent within the group of smallest enterprises. The outcomes of a large household survey held in 1997 in Brazil show that within the size class of micro enterprises (enterprises with no more than 5 paid employees, irrespective of their degree of formalization), more than 85% does not employ any paid employees. As the number of paid employees increases, the share of informal workers decreases, just as the share of enterprises that does not pay social contribution, see Table 5.1

**Table 5.1:**  
Size distribution and employment composition of Brazilian micro-enterprises in 1997

Source: Fajnzylber et al. (2011), Table 1

Number of paid employees	Share of micro-firm sector	Informal workers / paid workers (%)	Pay social contribution (%)
0	86.6	–	7.1
1	7.4	71.6	27.0
2	3.0	58.8	37.8
3	1.6	52.8	49.3
4	1.0	43.8	53.2
5	0.5	44.7	49.4

In 1996 the Brazilian government introduced SIMPLES, a programme that has reduced tax rates and tax regulations for a considerable part of the Brazilian micro firms. The purpose of this programme was to enable small, unskilled labour-intensive firms to compete more effectively with larger firms. A reduction of tax rates and tax regulations is assumed to have a positive effect on the competitiveness of these enterprises, not only because of the direct effect of the tax reduction (which is only relevant to those firms that actually pay taxes and social contributions) but also because it may stimulate firms to formalize (which may also affect their competitiveness).

Various studies have been performed to find out if SIMPLES has had a significant effect on the degree of formalization. This case study is based on a study by Fajnzylber, Maloney and Montes-Rojas that appeared in the Journal of Development Economics in 2011 (Fajnzylber et al., 2011).

### 5.2 Problem definition

In Brazil, enterprises need to get registered and obtain licenses with different institutions operating at different regional levels. Because of this, it is possible to distinguish between different degrees of formalization of Brazilian enterprises. For four different types of license and registration, Fajnzylber et al. (2011) show the registration rate of micro firms in 1997. For each of these types, less than half of all Brazilian micro firms had obtained the license or got registered. In addition, a large share of the registered micro enterprises did not pay social security contributions in 1997 (Table 5.1).

**Table 5.2:**  
Formality indicators for Brazilian  
micro enterprises (1997)

Source: Fajnzylber et al. (2011),  
Table 3

Indicator	All micro firms (%)	Micro firms with at least one employee (%)
License to operate	23.2	31.1
Legal entity	14.4	42.6
Micro-firm registration	11.3	33.7
Registered with tax authorities	13.0	39.1
Paid taxes	6.7	17.0
Paid social security	7.9	24.8

The informal nature of micro enterprises can have negative effects on their competitiveness, for example because it limits their access to formal credit markets and government provided business development services, and because it makes them less attractive employers for high-skilled employees. Also, being informal hampers the ability of enterprises to establish property rights over their investments. This could reduce their willingness to invest in fixed property and to establish their enterprise at a permanent location.

These negative effects of being informal imply positive effects of becoming formal. These positive effects may, however, not exist for all enterprises. The benefits of formalization depend on the entrepreneurial qualities of the entrepreneur. For entrepreneurs with few qualities, the benefits of formalization may be very small. For these firms, getting access to formal credit institutions or the foreign market will be unimportant.

The main objective of SIMPLES was to improve the competitiveness of micro firms, by reducing costs and stimulating formalization. Fajnzylber et al. (2011) examine the following three research questions:

- ▶ Did the introduction of SIMPLES affect the decision of micro enterprises to formalize?
- ▶ Did formalization improve firm performance (in terms of revenues and profit)?
- ▶ Through which channels did this occur?

Regarding the second research question, it is important to realize that this is about the effects of formalization in general, not about the effect of SIMPLES.

### 5.3 Regulatory response

The SIMPLES programme combines a reduction of taxes and social contributions with a simplification of the procedures involved. The main features can be summarized as follows:

- ▶ Simplification of the tax system, by replacing a set of different taxes and social contributions by a single contribution (to be paid once a month).
- ▶ Reduction of the total amount of taxes and social contributions to be paid (an overall reduction of up to 8% in the tax burden was obtained).

- ▶ Making the amount of social security contributions independent of the amount of wages paid to employees. The amount of social security contributions is determined as a fixed percentage of total revenues (instead of a percentage of payroll contributions). This may stimulate enterprises to hire employees and/or legalise already existing informal labour relationships.
- ▶ Originally, taxes at state and municipal level were not included. Later, these could be included (provided that the states and/or municipalities involved came to a formal agreement).

The SIMPLES programme targeted micro firms (turnover up to USD 109 091) and small firms (up to USD 654,545)<sup>41</sup>. However, some occupations, activities, sectors and/or enterprises were excluded:

- ▶ All activities that by law require the employment of professionals with regulated occupations (such as, for example, manufacturing of chemical products, and education and health services).
- ▶ Some specific sectors were excluded (financial services, real estate, private security, warehousing, manufacture of tobacco and beverages)
- ▶ Incorporated companies and firms with government of foreign ownership were excluded.

These exclusions made sure that SIMPLES would target unskilled, labour-intensive firms.

## 5.4 Implementation of reform

The study by Fajnzylber et al. (2011) does not contain an elaborate description of how SIMPLES was implemented. Instead, only those aspects were included that appeared to be relevant for the research request of their study:

- ▶ SIMPLES was introduced in November 1996.
- ▶ The introduction of SIMPLES was accompanied by a widespread information campaign, which was later discontinued.
- ▶ Originally, a 5% tax rate (of revenues) for all micro and small firms was introduced. After a month, the tax rate differentiated between micro firms and small firms.
- ▶ Firms could opt for using SIMPLES either at the time of registering with the tax authority, or by altering an already existing tax registration.
- ▶ After enrolling, SIMPLES would become active on the first day of the following calendar year. An exception was made for the first year of the programme. For firms that enrolled before April 1997, SIMPLES would become active from January 1997 onwards. The incentive to enrol in SIMPLES is therefore higher during the first quarter of 1997 than during the rest of 1997.

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<sup>41</sup> In October 1997 (at which time the survey took place), one Brazilian Real (RS) was equivalent to US\$ 0.909 (Fajnzylber et al., 2011). We have used this exchange rate to determine the US\$ equivalent of the monetary boundaries (which are statutorily defined in RS).

## 5.5 Results achieved

This case study does not compare firms that participate in SIMPLES with firms that do not; instead, it examines to which extent the introduction of SIMPLES affected the decision to formalize for all eligible firms, and how this decision in turn affected firm performance.

### Heuristic framework

A heuristic model is presented that captures the (outcomes of the) decisions of enterprises. It is based on the following relations:

- ▶ Firm performance (Y) is modelled as a function of two production factors: the formality of an enterprise and entrepreneurial ability (which captures all other production factors).
- ▶ It is assumed that both production factors have a positive (marginal) return: given certain entrepreneurial abilities, being formal will result in a higher performance level. And given the degree of formality, higher entrepreneurial abilities will result in a higher performance level.
- ▶ The benefits of becoming formal will increase with entrepreneurial ability. This implies that for firms with very low entrepreneurial abilities, the positive effect of formalizing will be limited.
- ▶ Formalization involves paying a tax, so there are costs associated with formalization.
- ▶ Firms will formalize only if the returns to formalization are larger than the costs of formalization.

SIMPLES can be interpreted as a measure that reduces the costs of formalization. The heuristic model sketched before suggests that the introduction of SIMPLES will only affect a certain proportion of all eligible micro firms:

- ▶ For firms with high levels of entrepreneurial ability, the returns to formalization are higher than the costs of formalization before the introduction of SIMPLES. These firms will formalize (or already have formalized) even without the introduction of SIMPLES, so for these firms the introduction will have no effect.
- ▶ For firms with low levels of entrepreneurial ability, the returns to formalization are lower than the costs of formalization after the introduction of SIMPLES. These firms will not formalize even with the introduction of SIMPLES, so also for these firms the introduction will have no effect.
- ▶ For the remaining firms (with entrepreneurial abilities that are neither too high nor too low), the introduction of SIMPLES may affect the balance between the expected costs and benefits of formalization.

## Estimation methodology

The theoretical framework is used to derive a few equations that formalize how the dependent variable of interest may be related to a set of independent variables (including control variables). The following equations are estimated:

- ▶ Explaining different formality indicators (those included in Table 5.2), using eligibility status and start-up date (before or after introduction of SIMPLES) as main explanatory variables.
- ▶ Explaining different firm performance measures (revenues and profits), using the license to operate as indicator of formality<sup>42</sup> and a set of firm-specific and entrepreneur-specific characteristics as explanatory variables.
- ▶ To examine which channels may explain the effects of formalization on firm performance, a number of equations are estimated where the explanatory variables are related to a few specific channels (employment, paid employment, amount of fixed capital, whether or not the enterprise had access to credit, whether or not the enterprise operates from a permanent location).

These equations are estimated using the outcomes of the Brazilian Survey of the Urban Informal Sector (ECINF) held in October 1997 amongst 50 000 households. This survey targeted individuals who claim to be self-employed or owner of an enterprise with up to 5 paid employees. Rural areas are excluded from this survey<sup>43</sup>, probably because it is assumed that the informal sector will be small in these areas<sup>44</sup>. Analysis is restricted to those micro firms that started between February 1996 and October 1997.

The available data show a discontinuity in the time series of the different formalization indicators: for almost all indicators, the formalization degree of enterprises that started just before the introduction of SIMPLES is considerably lower than the formalization degree of enterprises that started right after the introduction of SIMPLES. This discontinuity can be exploited using specific regression discontinuity estimators.

Two different (but related) estimation techniques are then used to estimate these equations. These estimation techniques include a difference-in-difference approach<sup>45</sup> and a regression discontinuity estimator<sup>46</sup>.

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42 Other formality indicators were also used, but the results of these estimations were not reliable enough.

43 Additional details on the Survey are based on the following website: [http://mospi.nic.in/informal\\_paper\\_12.htm](http://mospi.nic.in/informal_paper_12.htm) (accessed on July 12 2013)

44 The definition of the informal sector that is used for this survey excludes agricultural activities. To the extent that a large share of activities in rural areas is agricultural, the informal sector in rural areas will be small by definition.

45 In a difference-in-difference approach, a) differences before and after the introduction of SIMPLES are determined, and b) the extent to which these differences are different for a treatment group of eligible firms as compared to a control group of non-eligible firms.

46 This is a recently developed regression technique that exploits the discontinuity in the data that can be observed around the time of the introduction of SIMPLES. By exploiting this discontinuity, it is not necessary anymore to include a control group of non-eligible firms. The estimator based on this approach (labelled "before-after" or BA) therefore only uses the subsample of eligible firms.

## The effects of SIMPLES on formality (estimation results – first stage)

The main findings are summarized below.

- ▶ First of all, 72% of firms that attempted to register, report having no difficulties in the process. This suggests that in Brazil, barriers to entry are not the principle drivers of informality.
- ▶ Next, the results show that, overall, the introduction of SIMPLES had significant positive effects on the level of formality. Depending on the specific estimation technique used, the results show that the introduction of SIMPLES led to:
  - License to operate: an increase of 7.1% or 11.6%.
  - Firms registered as legal entity: an increase of 6.4% or 7.5%.
  - Micro-firm registration: an increase of 5.7% or 6.3%.
  - Registration with tax authorities: an increase of 2.8% (not significant) or 7.2%.
  - Tax payments: an increase of 3.1% or 4.6%.
  - Social security contributions payment: an increase of –1.4% (not significant) or 4.3%.
- ▶ The size of these positive effects tends to be twice as large for firms with paid employees as compared to firms without paid employees.

## The effects of formality on performance (estimation results – second stage)

The main finding is that across all specifications, formalized firms show significantly higher revenues and profit levels. For the preferred model specification<sup>47</sup> and for enterprises with and without paid employees, the main findings are that:

- ▶ revenue levels are 55%–57% higher, and
- ▶ profit levels are 45%–49% higher.

Also here, the size of these positive effects is larger for firms with paid employees as compared to firms without paid employees.

## The channels through which formality affects performance (estimation results – third stage)

The estimated effects of formalization (measures as having a licence to operate) on revenues and profits are quite large. Further analysis suggests that these effects seem to occur through the following channels:

- ▶ Employment levels. Formality leads to an increase in employment, largely in paid employees.

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<sup>47</sup> Weighted least squares estimates of the BA estimator and the difference-in-difference estimator.

- ▶ Choice for location. The results suggest that the decision to formalize affects the choice to operate from a permanent location (this also suggests that the decision to formalize or not is often made during the start-up phase). Enterprises that decide to become a formal enterprise are more likely to operate from a permanent location. This increases their possibilities to build and expand their capital stock and hire additional employees. “Entrepreneurs appear to choose a different scale and arguably, technology of production, even type or quality of product when they register their firm at the time of start-up, than if they do not” (Fajnzylber et al., 2011, page 274).
- ▶ Formalization had no clear effect on the access of enterprises to external capital.

## 5.6 Lessons learnt and conclusions

The context of SIMPLES is that it was introduced in a country that scores relatively low on the ‘easy of doing business’ index (see Section 3.3). This is particularly the case for paying taxes: although the costs of *becoming* formal (time and monetary costs involved with obtaining licenses and getting registered) are relatively high (as compared to other countries), the costs of *being* formal (taxes, social security contributions) appear to be even higher.

The SIMPLES case shows that, in this context, a programme that reduces the costs of *being* formal and that relates these costs to revenues rather than payroll contributions can have significant positive effects on the degree of formality. Becoming formal, in turn, increases the likelihood that the enterprise will operate from a permanent location and hire paid employees. The finding that having a license to operate affects employment levels, suggests that the reduction in social security contributions (and/or that the amount of these contributions is related to total revenues rather than the payroll contribution) plays an important role. Unfortunately, it is not clear to which extent this positive effect is due to the reduction in the amount of social security contributions, or to the fact that the amount of these contributions is determined by revenues instead of paid wages.

This case also shows that the decision to formalize or not is mostly taken during the start-up of an enterprise. This suggests that policies to promote the formalization of enterprises may be more effective if they focus on start-ups.

### On the generalisability of SIMPLES

The results of this case are restricted to the urban informal sector. It is not clear to which extent these results will also occur in rural areas.

## 6 Case study 3: Individual Micro-entrepreneur (Brazil)

### 6.1 General overview

This case study presents the Individual Micro-entrepreneur Programme implemented in Brazil. Following the DCED informality policy fields, this programme is a “taxation policy and administration” scheme.

The Individual Micro-entrepreneur (MEI) is an innovation of the Brazilian tax system approved with the Supplementary Law No. 128, of the 19<sup>th</sup> of December of 2008. In particular, this programme means the creation of a new band at the base of the pyramid of the Simple National tax system, which already has a simplified taxation scheme for small and micro enterprises.

The Supplementary Law No. 128 provides favourable conditions for self-employed workers who want to legalise their small business. More precisely, the Individual Micro-entrepreneur programme allows the formalization of the worker at low costs, with pension coverage for the micro-entrepreneur and his/her family.

This case study is based on the information collected from three different sources: the paper prepared by Silas Santiago (*Microempresas e Empresas de Pequeno Porte. Brasil: A experiência do Simples Nacional e do Microempreendedor Individual*, 2011), a publication by the Ministry of Social Welfare of Brazil in 2011 (“Los desafíos de la Seguridad Social en Brasil en el contexto actual”) and another report from Marcelo Neri and Adriana Fontes prepared in 2010 (“Informalidad y Trabajo en Brasil: Causas, consecuencias y políticas públicas”).

### 6.2 Problem definition

The informal economy in Brazil is closely related to the share of micro and small enterprises (correlation between size of company and prevalence of informality):

- ▶ These activities are characterized by different forms of informality: legal, productive<sup>48</sup> and business informalities.
- ▶ Only 24% of micro-entrepreneurs contribute to the Social Security Institute.
- ▶ Within micro and small enterprises, 48% of the workers are informal workers.

Concerning the causes of the informality among the Brazilian production units, the following aspects are at stake:

- ▶ The Brazilian tax system is one of the most complex and expensive in the world (the country occupies position 150 in tax paying).
- ▶ The amount spent on paying taxes represents an average of 70% of the total gross income.

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48 This refers to informal workers in low quality jobs with a particularly low labour productivity.

- ▶ The tax burden is around 35% of GDP.
- ▶ High taxes and bureaucracy are not clearly translated into benefits for the population.

Consequences of informality in Brazil:

- ▶ Distortions and economic inefficiencies.
- ▶ Uncertainty about the future fiscal situation.
- ▶ Unstable incomes for employees resulting in unstable tax base.
- ▶ Lack of social protection for a significant proportion of the population.
- ▶ Income inequality among population.
- ▶ Negative effect on productivity and economic growth.

### **6.3 Regulatory response**

The Supplementary Law No. 128, of the 19th of December of 2008, established special conditions for informal workers with the Individual Micro-entrepreneur Programme (MEI), as a way of promoting formalization.

In fact, the Individual Micro-entrepreneur Programme is the largest programme in Brazil whose objective is the inclusion of informal enterprises in the formal sector and hence the reduction of business informality.

This programme has as main objective the formalization and social protection of entrepreneurs with less than USD 36,000 gross income per year, through the payment of fixed monthly amounts.

### **6.4 Implementation of reform**

The Individual Micro-entrepreneur Programme (MEI) was implemented in July 2009 in order to increase the coverage of small entrepreneurs.

#### **Requirements to register as an Individual Micro-entrepreneur:**

- ▶ The individual entrepreneur may not have annual gross revenues above USD 21,800 until 2011, and not above USD 36 000 from 2012 onwards.
- ▶ Not to have business branches.
- ▶ Not to be owner, partner or director of another company.
- ▶ Not to have more than one employee.
- ▶ The entrepreneur must carry out activities listed in the annex to the Individual Resolution CGSN (27th April 2009), which includes more than 450 different occupations.

### Payments of monthly fixed amounts:

- ▶ The contribution to social welfare is 5% of the national minimum wage.
- ▶ There is a fixed amount to be paid every month. This amount is yearly adjusted according to the minimum wage. In 2009, this amount was between USD 17 and 20.
- ▶ This amount includes: the contribution of the individual entrepreneur to social security, the national tax on goods circulation and provision of interstate and inter-municipal transport and communications services (ICMS), and the municipal tax on services of any nature (ISS).
- ▶ Individual micro-entrepreneurs are exempted from paying other federal taxes.

The Individual Micro-entrepreneur can have a single employee who receives the general minimum wage or the minimum wage of the corresponding professional category. The Individual Micro-entrepreneur, in addition to the fixed personal amount, must also pay every month:

- ▶ 3% of the remuneration of the employee, to be paid by the employer to the social security system.
- ▶ 8% of the remuneration of the employee, as fee deducted from employee salary for the Fund of Guarantee of Time of Service (FGTS<sup>49</sup>).

### Benefits of the Individual Micro-entrepreneur

- ▶ It allows the formalization of the worker at a low cost.
- ▶ Pension coverage for the MEI and his or her family:
  - for the micro-entrepreneur: allows retirement due to age and disability, disease subsidies and maternity salaries.
  - for his/her family: imprisonment allowance and pension upon death.

### Individual Micro-entrepreneur registration procedure

- ▶ The MEI registration process is very simple and is done through the web portal: [www.portaldoempreendedor.gov.br](http://www.portaldoempreendedor.gov.br).
- ▶ There is card issued with monthly payments.
- ▶ An Individual Micro-entrepreneur Certificate (CCMEI) is issued.
- ▶ Payments are made monthly.
- ▶ An annual statement is presented every year in the month of May.
- ▶ The registration in the National Register of Legal Persons (CNPJ) facilitates the opening of bank accounts, the application for loans and the issuing of invoices.

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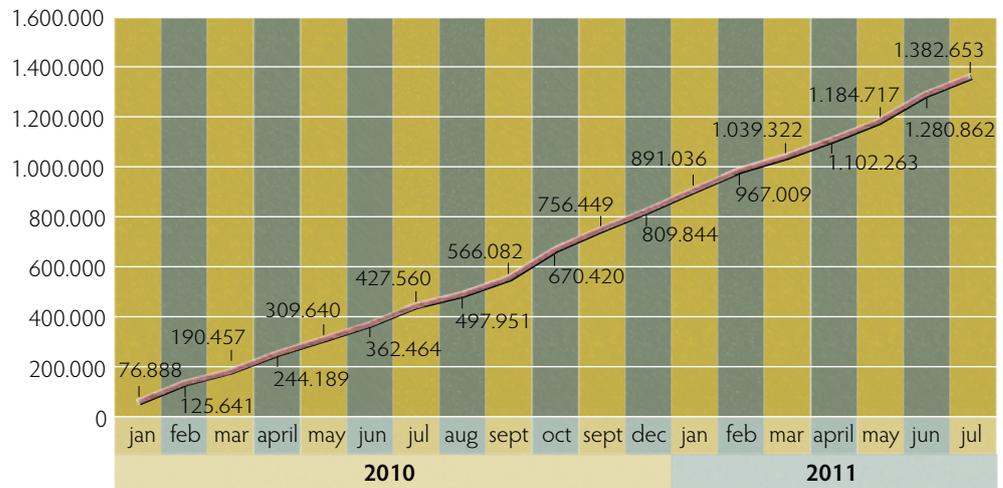
<sup>49</sup> The Fund of Guarantee of Time of Service (FGTS) is a set of resources taken from the private sector (businesses in general) and managed by CEF (Caixa Econômica Federal, public financial institution) with the primary purpose of supporting workers in some cases such as the end of the employment relationship, situations of serious illness, and even in some cases of natural disasters, and also for investments in housing and infrastructure.

## 6.5 Results achieved

The Individual Micro-entrepreneur Programme (MEI) addressed a total of 10.3 million informal entrepreneurs in Brazil, and has managed to register nearly 1.4 million workers until July 2011 (See Figure 6.1).

**Figure 6.1:**  
Development of the number of micro-entrepreneurs January 2010–July 2011

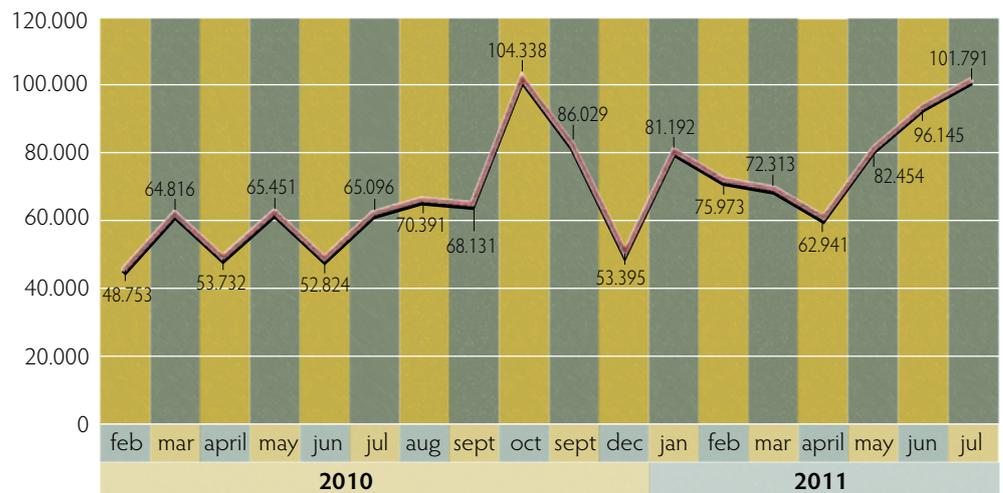
Source: Ministry of Social Welfare (2011) *Los desafíos de la Seguridad Social en Brasil en el contexto actual*



The number of new registrations per month is shown in Figure 6.2.

**Figure 6.2:**  
Number of new registrations per month, February 2010–July 2011

Source: Ministry of Social Welfare (2011) *Los desafíos de la Seguridad Social en Brasil en el contexto actual*



## 6.6 Lessons learnt and conclusions

These are the conclusions that can be reached from this case study:

- ▶ The Individual Micro-entrepreneur is a person who works on its own and who legalises his/her activity as a small business.
- ▶ The Individual Micro-entrepreneur can also hire one employee, who receives the minimum salary.

- ▶ One of the main advantages of this law is the registration in the National Register of Legal Persons (CNPJ), which facilitates the opening of bank accounts, the application for loans and the issuing of invoices.
- ▶ The Individual Micro-entrepreneur pays a monthly fixed amount that is adjusted annually in accordance with the minimum wage.
- ▶ Thanks to these contributions, the Micro-entrepreneur has access to benefits, such as support for maternity, sickness or retirement, among others.

Informality among production units is a very important phenomenon in Brazil that has many dimensions. Due to its complexity, it must be approached with a set of integrated measures, including:

- ▶ Provide adequate incentives for formalization.
- ▶ Reduce information asymmetries in the informal economy.
- ▶ Redefine the relationship between public institutions and enterprises and workers.

# 7 Case study 4: Municipal reforms (Brazil)

## 7.1 General overview

Efforts to make it easier for individuals to register a business have been a very common form of regulatory reform over the past decade. Since 2004, 75% of the countries included in the Doing Business survey have adopted at least one reform making it easier to register a business (IFC, 2009). There is some evidence that, starting from a point of burdensome entry, large reductions in entry barriers are associated with increases in firm registrations. Djankov et al. (2002b) show that countries with more burdensome entry regulations have larger informal sectors, while Klapper et al. (2006) find that costly entry regulations are associated with the creation of fewer limited liability companies.

Recent research has suggested there is little benefit to reform if the reduction in the entry barriers are not large (Klapper and Love, 2010), and despite these reforms, the majority of firms in many developing countries remain informal. The number of informal firms that register when a reform makes it easier to do so is small compared to the overall stock of informal firms. While there is evidence that distance and information serve as barriers to some firms registering that would benefit from doing so (McKenzie and Sakho, 2010), several recent experiments which have provided firms with information on how to register, and which have lowered the cost of registering, have found very few informal firms formalize as a result (de Mel et al, 2013 in Sri Lanka; Jaramillo, 2009 in Peru; Andrade et al, 2012 in Brazil). One explanation appears to be that very few informal firms seem to benefit from formalizing, especially those outside the main cities.

This case study is based on a publication by Miriam Bruhn and David McKenzie (Bruhn and McKenzie, 2013a). This evaluation was made at the request from the State Government of Minas Gerais, Brazil. It uses administrative data to evaluate the impact of Minas Fácil Expresso, a programme in the state of Minas Gerais, Brazil, which attempted to expand a business start-up simplification programme to more remote municipalities.

## 7.2 Problem definition

As mentioned in the previous section very few informal firms seem to benefit from formalizing. This raises the question of whether government efforts to extend simplification efforts to firms outside the main cities will lead to increased formalization rates, given the likelihood that such firms may be even less likely than firms in large cities to reap the supposed benefits of formalizing like increased customer bases, access to government programmes and contracts, and access to finance. The programme was meant to extend the simplification programme that existed in the most populous municipalities in the state Minas Gerais to the 822 unserved municipalities which are generally smaller and had fewer pre-reform registrations than the larger municipalities already covered by the programme.

The paper aimed to:

- ▶ study the impact on firm registrations in the municipalities concerned.
- ▶ look into the effect on received business taxes in the municipalities concerned.
- ▶ provide an example to other developing countries to evaluate such reforms by using administrative data.
- ▶ address the concern that evaluations that show little (positive) impacts are often not published, the authors are hoping that sharing these results will contribute to “learning from failure”.

### **7.3 Regulatory response**

The programme in this state with about 21 million inhabitants on a land area slightly larger than France consists of setting up a “one stop shop” for registration by integrating the different municipal, state, and federal entities involved in registering a firm.

### **7.4 Implementation of reform**

Originally such one stop shops were set up in 31 of the state’s 853 municipalities, covering the most populous municipalities with already the highest levels of firm registration. The simplifications resulted in a reduction from 8 to 4 steps in the procedures required to register, and a reduction in the time it takes to register from 28 to 9 days (Barbosa et al, 2011).

In some municipalities, there was also a reduction in the fees required for registering. The licensing process requires a feasibility consultation (Consulta de Viabilidade) that was conducted by the local authorities for a fee that varied between 7 USD and 48 USD, depending on the municipality. With Minas Fácil Expresso, the consultation is done online for free. In addition, many municipalities had previously required that owners pay back any debt relating to unpaid property taxes before registering, and this is now no longer required.

The present programme tried to extend the benefits of this programme to firms in the other 822 municipalities in the state. The idea was to have a quick and cheap way of reducing informality and increase state and municipal tax collection (Barbosa et al, 2011). Before the opening of Minas Fácil Expresso, entrepreneurs had to travel to a city with a Minas Fácil office to register their business with federal and state level authorities, and in addition to register with the local municipality. From September 2011 up to August 2012 a total of 55 municipalities participated.

### **7.5 Results achieved**

#### **Administrative data used**

The authors used three types of administrative data provided by the Minas Gerais Chamber of Commerce (covering the 822 municipalities mentioned in the previous section):

- ▶ list of municipalities in which an express office was planned to be implemented and municipalities in which an express office was actually implemented with implementation dates.
- ▶ monthly data from the period January 2008 – August 2012 on the number of firms registered as formal entities in each municipality.
- ▶ monthly total municipal tax payments received in each municipality from January 2008 till October 2012.

## Methodology

To have a good estimate of the effect of the measure the so-called difference-in-difference methodology was applied. This means that outcomes are observed for two groups for two time periods. One of the groups is exposed to a treatment in the second period but not (yet) in the first period. The second group, the control group, is not exposed to the treatment during either period.

Table 7.1 presents an illustration of how impact is calculated using the difference-in-difference approach.

**Table 7.1:**  
Calculating impact of reform with the difference-in-difference approach

	Treatment Group	Control group
Before reforms start	$T_{\text{Before}}$	$C_{\text{Before}}$
After reforms were implemented	$T_{\text{After}}$	$C_{\text{After}}$
Impact = $(T_{\text{After}} - T_{\text{Before}}) - (C_{\text{After}} - C_{\text{Before}})$		

To have a proper control group, i.e. units of measurement that have similar characteristics of the units in the treatment group, propensity score matching was applied (Dehejia and Wahba, 2002).

## Results

The authors estimate that the opening of a Minas Fácil Expresso office in a municipality has on average resulted in a reduction in registrations of about one firm per month (about 10% fall in registrations). This result is statistically significant at the 5% level using different control groups.

So the evaluation concludes that the reform has had a negative effect: a reduction in registration in the municipalities where the reform was applied instead of an increase! This negative impact of the reform is found to be concentrated in the month that the Minas Fácil Expresso office was opened and the month immediately after opening (some 187 fewer registrations in the opening month and 154 fewer firms registering during the next month).

One reason why the number of registrations fall during the first period is that delays in registration may occur during an adjustment period until the new system is running smoothly. However, this should have led to increases in completed firm registrations in

later months, which the authors did not find. An additional reason suggested by the authors why no positive effect of Minas Fácil Expresso is found is that some firms might not want to register with all three levels of government. The new system unifies municipal, state, and federal procedures, while before firms had the option of registering with only one or two of these authorities, thereby evading fees and taxes associated with the others. Taking away this flexibility may make some firms less likely to register.

Another objective of the study was to look into the effects of reforms on business taxes received by governments. The authors conclude with regard to the impact of Minas Fácil Expresso on Municipal Tax Receipts on the bases of rather similar control groups that there is no significant impact on tax revenues, which is consistent with what would be expected given the relatively small (downward) change in registration rates.

## **7.6 Lessons learnt and conclusions**

The bases for this evaluation are three observations:

1. Over the past decade – given a.o. the World Bank/IFC's Cost of Doing Business project – efforts making it easier to formally register firms, for example by setting up one stop shops, have been the basis of many policy recommendations and have been widely implemented. Since 2004 75% of the countries in the Cost of Doing Business survey have adopted at least one reform making it easier to register a business (IFC 2009).
2. There is some evidence that, starting from a point of burdensome entry, large reductions in barriers to entry are associated with increases in firm registrations (Djankov et al (2002b), Klapper et al (2006)).
3. Recent evidence has questioned the view that most informal firms would like to formalize, as there are often few benefits to them of doing so. This is particularly likely to be the case in more isolated municipalities.

Based on government administrative data, this evaluation of the impact of the opening of Minas Fácil Expresso offices to ease registration in more remote municipalities in the state of Minas Gerais in Brazil resulted in the finding that opening these offices actually led to a small reduction in the number of firms registering in the first two months, and zero increase or perhaps small decreases in registration rates in subsequent months and no significant changes in tax revenues.

This reform therefore does not appear to have met its goal of increasing formality in these municipalities, suggesting the need for policymakers to consider further what the other constraints to formalize are – and in particular – what would be the costs and benefits of drawing more of them into the formal sector.

## 8 Case study 5: Law 1429 (Colombia)

### 8.1 General overview

This case study presents the information collected concerning the Colombian measure 'Law 1429 for Employment Formalization and Generation'. In particular, the Law 1429 is aimed at implementing measures for the formalization and creation of employment and enterprises. The information presented in this report will focus on 'business formalization'.

The Law 1429 was proposed by the Executive Government and approved by the Colombian Congress in December 2010. It is still in force. With regard to its scope, it must be noted that it includes a wide collection of measures 'concerning the formalization of both employment and businesses'. Moreover, the Law 1429 not only introduces incentives or measures to formalize business and employment, but also to hire vulnerable social groupings and the regulation of CTAs (or 'cooperatives of associated work'). As there are measures affecting exclusively small companies, the Law itself defines small companies as those enterprises which have no more than 50 workers and whose total assets are not higher than 5,000 minimum monthly salaries.

Taking into account the DCED informality policy fields, the Law 1429 touches a number of such fields. On the one hand, it includes measures linked to "business registration and licensing", "taxation policy and administration" and "social protection". On the other hand, the business development programmes approved by this Law also refer to the fields "financial services" and "access to information about business regulation and rules".

The Law 1429 has clearly been supported by the Colombian chambers of commerce, which promote initiatives aimed at facilitating the creation of enterprises and business formalization.

Finally, for the elaboration of this case study, two sources of literature have been used:

- ▶ The report presented by the Economic Analysis Committee of Confecámaras (Colombian Confederation of Chambers of Commerce), which analyses the impact of the Law 1429 on the number of new businesses registered.
- ▶ One of the bulletins of the Labour Market and Social Security Observatory of the University Externado, which presents the issue of informality in Colombia and the effects of the Law 1429.

### 8.2 Problem definition

The Colombian 'Law 1429 for Employment Formalization and Generation' was passed in order to face the problem of business and employment informality that the country was facing at that moment.

In this regard, it is interesting to look at the 'World Development Indicators and Global Development Finance', published in the report by Confecámaras (2011), even if these data are approximate and there is a great deal of hidden information. According to this

source, 38.7% of companies in Colombia think that a typical company in Colombia registers less than 100% of its sales in order to avoid taxes.

Moreover, even if the Colombian economy has experienced an accelerated increase during the last 10 years, it seems that this growth has not helped reduce the problem of informality which affects the country (Farné et al., 2011).

As a result, the Government of Colombia decided to launch the Law 1429, as a way of adopting new measures for facilitating formalization and creating new small enterprises, as well as for establishing the tax basis for those businesses that remained informal.

### **8.3 Regulatory response**

The Law 1429 is a comprehensive regulation which deals with six different areas of interest (Farné et al., 2011):

1. Programmes for business development (article 3).
3. Temporary reduction of costs of some legal requirements to be fulfilled by small companies during the first years of their existence (articles 4, 5, 6 and 7).
4. Incentives for the generation of employment among disadvantaged collectives (articles 9, 10, 11 and 13).
5. Dispositions concerning CTAs ('cooperatives of associated work').
6. Red tape simplification (articles from 17 to 23).
7. Creation of the National System of Information on employment demand (articles from 51 to 59).

### **8.4 Implementation of reform**

With regard to business formalization, the most important measure of the Law 1429 is the reduction of costs related to a number of legal requirements for small companies.

One of the most important measures is the reduction of the trade registration costs and its yearly renewal. There are also reductions in several taxes, such as income tax, source withholding (anticipated tax collection mechanism), payroll taxes, and also in the contributions to the Solidarity and Guarantee Fund for the health system. These reductions decrease over time (that is, each year the discount is lower), and they disappear at the sixth year of operation of the company. Furthermore, the Law 1429 foresees an amnesty for companies that in previous years did not renew their trade register (i.e. did not pay for the annual register levy). Moreover, inactive small companies can also benefit from this progressive costs reduction in relation to the payment of taxes (Farné et al., 2011).

The 'business development programmes' constitute a much wider and more generic initiative, and are not exclusively aimed at small companies. The objective is to revise all existing programmes and design new ones for promoting business formalization. The organization of 'business development programmes' is managed by the Ministry of

Commerce and Industry. Essentially, 'business development programmes' should include (Farné et al., 2011):

- ▶ Credits and microcredits for companies created by people younger than 28.
- ▶ Technical and financial support for the creation and formalization of businesses and employment in the rural sector.
- ▶ Training and specialised assessments for the creation and formalization of businesses and employment

In addition to these initiatives, the Law 1429 has also simplified labour formalities for employers to hire employees, as well as other bureaucracy issues.

## **8.5 Results achieved**

It is complicated to find out how many companies have benefited from the Law 1429 and to evaluate its impact. The law itself did not foresee a specific monitoring system of the results, and information available is scarce. The impact of the 'business development programmes' for instance cannot be assessed, as they include very broad ideas and principles of universal acceptance, whereas the amount of resources devoted to these plans are not specified (Farné et al., 2011).

According to Confecámaras, between January and August 2011, 174,782 new companies were constituted in Colombia. This means 9.6% enterprises more than the year before (period January- August 2010, with 158 550 new companies), but only 2.1% more than 3 years before (170 130, in the period January- August 2008).

Out of the 174 782 new companies constituted in total (period January- August 2011), 144 523 new small companies had the opportunity to benefit from reductions concerning the trade register. Approximately 50% of them do not employ salaried personnel and they just perform small professional activities.

In addition to these 144 523 new small companies, 87 043 already existing small companies benefited from the amnesty included in the Law 1429 (meaning that they had not paid for the annual trade register). Overall, this implies that 231 566 small companies were able to benefit from discounts related to the trade register derived from the Law 1429.

Before the approval of the Law 1429, the chambers of commerce of Colombia had already started implementing their 'business formalization programmes'. Therefore, it is not possible to distinguish to which initiative in particular new businesses respond. Just to give an example, the chamber of commerce of Bogotá (capital city of Colombia) reported that 7,134 businesses were formalized thanks to its own 'business formalization programme'. However, at the same time, these companies represent 18.9% of the new small companies registered which benefited from the Law 1429.

As a whole, it is not clear if this significant increase in the number of new small companies (between January and August 2011) represents a step ahead towards formalization. Moreover, it is not clear if it was really due to the Law 1429 (Farné et al., 2011).

## 8.6 Lessons learnt and conclusions

At first glance, the Law 1429 is a well-intentioned tool, but it turns to be insufficient for solving efficiently the complex issue of informality in Colombia. Essentially, this law consists of a collection of measures which, on the one hand, try to improve the benefits of formality, and, on the other hand, are aimed at reducing the costs of formalization formalities (Farné et al., 2011).

Some of the costs reduction measures (trade register, tax payments, Solidarity and Guarantee Fund) are temporary, and therefore, their influence on businesses' decision about formalization could be just a 'short-term' influence. Furthermore, the level of savings for the company may not be high enough for affecting businesses' formalization decisions; that is, the reduction of costs may still not compensate for informality conditions (Farné et al., 2011).

Most important lessons learnt are the following (Confecámaras, 2011):

- ▶ To begin with, appropriate information and dissemination of the requisites and legal formalities that formal business must fulfil should reduce informality levels. Easy, clear and didactic language leads to a better understanding of legal requirements.
- ▶ The lack of adequate, simple instruments for the national supervision of economic activities creates many difficulties and obstacles to create new formal companies. The Government shows mistrust/caution by excessively regulating some economic activities with the consequence that regulatory mechanisms become too complex and this discourages the creation of formal enterprises (Confecámaras, 2011).
- ▶ In general terms, the reasons why businessmen formalize their companies are related to market requirements, rather than to a worry for legal penalties. In other words, apparently, the probability of penalties for micro and small of companies is low in comparison to the economic benefit they get from not fulfilling legal requirements.
- ▶ Entrepreneurs and business owners expect that the institutions that are responsible for imposing regulations and that are benefitting from such legal requirements give some compensation – some incentives and support to comply – for the efforts made by enterprises to comply with these legal obligations (Confecámaras, 2011).
- ▶ It makes no sense to implement measures aimed at the formalization of companies, if no flexible support and counselling is offered to formal enterprises and/or enterprises in the process of formalization.

As a consequence, it is important to (Farné et al., 2011):

- ▶ Modify the cost-benefit relationship between formality and informality in the initial stages of the formalization process, so that formalization turns to be a real advantage for companies.
- ▶ Reinforce the compliance with the law, make justice more transparent, and reduce excessive bureaucracy.

## 9 Case study 6: An experiment in Sri Lanka

### 9.1 General overview

This case study does not concern the evaluation of an existing policy. Instead, it discusses the setup and outcomes of an experiment that was conducted in Sri Lanka by De Mel et al. (2013) to measure the latent demand for formalization. For this experiment, a sample of more than 500 informal firms was drawn. These firms were assigned to four different treatment groups and a control group. The treatments consisted of two elements: firms were informed about the proper costs and benefits of formalizing, and they would receive a financial reward in case they decided to register (the treatment groups differ in the height of the reward). Once the experiment was closed, the researchers examined the effects of the different treatments on the registration rate of enterprises. In addition, they examined whether formalization had a measurable impact on several firm performance indicators.

One of the outcomes of this experiment is that the treatment has had a positive effect on the registration rate of enterprises, and that this effect is related to the height of the financial reward. The authors therefore conclude that the decision of firm owners whether or not to register is primarily a rational decision based on a comparison of the costs and benefits involved. Next, registration has a positive effect on the profitability of enterprises, even though these positive effects are restricted to only a few enterprises. The benefits of registration for other performance indicators were minimal (and not statistically significant). At the same time, a positive effect of registration is found on attitudes towards relevant levels of government.

### 9.2 Problem definition

As is the case in many countries, firms that want to formalize have to deal with multiple levels of registration. Two levels are required for all firms in Sri Lanka: obtaining a license at the municipal and at the divisional level. The benefit of a municipal license is primarily to prevent harassment by local officials, who control the most visible firms, as it is an important stream of revenue. The divisional registration serves as legal proof of the existence of a firm and is for instance required for tax purposes or to take out loans. Firms that have employees are required to register these employees with the Ministry of Labour, for the social security schemes. Finally, firms with revenues over a certain threshold (1.8 million LKR per year, some 15 750 USD) must also register for VAT.

The focus of this experiment is the decision of enterprises to register at the divisional level. Since this registration confirms the legal existence of a firm, it most closely corresponds to the concept of formalization (De Mel et al., 2013).

De Mel et al (2013) start their study by using survey data to identify what enterprises conceive as the most important costs and benefits of registration. In terms of costs, firms perceive the necessity to pay taxes and be visited by tax authorities to the most

commonly perceived cost, followed by the fact that the process of registration would be burdensome or too time consuming. Only 13% believed that the initial cost was too high. The survey showed that firm owners generally did not know facts related to registration, such as actual costs or process length. The most commonly perceived benefits were the possibility to take out loans and have a bank account dedicated to the company. 23% claims that there are no benefits to registration. Often, smaller firms (with 1–2 employees) feel that they are too small to register. However, a majority of firms with 10 or more employees are registered with the relevant authorities.

One of the benefits that are often associated with formalization is that this would reduce the risk for firms of having to pay fines or bribes in order to remain in business. The researchers do not think this is the case in Sri Lanka, as their preliminary survey shows that less than 1% of the respondents claim to have paid fines / bribes.

The goal of the experiment is “to understand the demand for formality” for firms with 1 to 14 employees (De Mel et al., 2013, page 127). In particular, the authors compare the exclusion (or romantic) view with the exit (or McKinsey) view on formalization. According to the exclusion view, which focuses on the costs of registering, the formalization rate of enterprises would increase substantially if the costs of registering would be reduced to zero. According to the exit view, this may however not be enough. According to this view, the decision whether or not to formalize is not based solely on the entry costs, but on the balance between the costs and benefits of registering. Benefits should be higher than just the entry costs to make it worthwhile to register, and higher benefits may result in higher registration rates. The purpose of the experiment is to see which of these views seems to be most relevant for the micro and small firms in Sri Lanka.

In addition to examining the effects of different treatments on the registration rate of enterprises, the authors also examined to which extent getting registered had a positive impact on various firm performance indicators.

### **9.3 Regulatory response**

Not relevant.

### **9.4 Implementation of experiment**

For this experiment, a sample of 520 firms was drawn that stated that they were not yet registered at the divisional level. These firms were located through various local door-to-door surveys (existing sample frames could not be used, because these generally are restricted to firms that are already registered at the divisional level). Next, these unregistered firms were assigned to four different treatment groups and a control group. The treatments consisted of two elements: firms were informed about the proper costs and benefits of formalizing, and they would receive a financial reward in case they decided to register. To be more precise, the following four treatment groups can be distinguished:

- ▶ Information and reimbursement. Firm owners were presented with an information brochure, designed in cooperation with the local chamber of commerce and divisional

secretariat. In addition to this information, delivered by trained research assistants, firm owners were told that they would be reimbursed for registration for 1 000 LKR or about 9 USD (slightly above the average registration fee).

- ▶ Information and 10 000LKR (88 USD) compensation.
- ▶ Information and 20 000LKR (175 USD) compensation.
- ▶ Information and 40 000LKR (350 USD) compensation.

The promised payments were relatively large compared to the actual size of firms in the study. The median monthly profit of the firms in the sample was approximately 25 000 LKR or 220 USD. The research team also made clear that cancelling registration immediately after registration and obtaining the reward was not an easy task. After stratification (for regions, firm size, industry, willingness to register as indicated in preliminary survey), the firms in the sample were randomly assigned to any of the four interventions.

The firm owners selected for the study were all approached by trained research assistants that were available for answering potential questions. The researchers also took care that their offer was considered credible, especially for interventions 2–4. Open house sessions were organised in the two cities where the experiment took place, and here also owners were given the confidence that the offer was real.

The research team initially gave firm owners 1–2 months' time to register their firm in order to receive the promised reward, but extended the period several times, for instance to account for the festivities after the Sri Lankan government declared victory after 25 years of civil war.

The experiment showed that it occurred several times that the firm was already registered, even though the owner declared in the survey that this was not the case. Sometimes this is attributed to a misunderstanding, in some specific cases the firm was registered by a family member or in a different entity. This was controlled for in the subsequent analyses.

## 9.5 Results achieved

### The effect of the treatments on the registration rate

From the 104 firms registered for the group with intervention 1 (only 1 000 LKR or 9 USD compensation), only one firm had registered at the end of the experiment. For the other three treatment groups the registration rate is considerably higher: for intervention 2 (10 000 LKR or 88 USD) 16 out of 104; for intervention 3 (20 000 LKR or 175 USD) 13 out of 105; and for intervention 4 (40 000 LKR or 350 USD) 30 out of 102.

However, these basis statistics do not correct for the differences that may exist in the sample characteristics of the different treatment groups. They also do not correct for the fact that some of the firms in the different treatment groups were in fact already registered. Although these firms were part of a treatment group, they did not actually receive a treatment offer where they could receive a financial payment if they would register before the end of the experiment.

To obtain a better estimate of the treatment effect (the effect of actually receiving a treatment offer), a regression equation was estimated that included different dummy variables to control for the stratification variables and dummy variables indicating whether or not an enterprise actually got a treatment offer (according to one of the four treatment groups) to register. In statistical terms, the first intervention did not yield significant results: the registration rate amongst these enterprises was not different from the rate one among the control group. For the other three treatment groups, the treatment effect was however significantly positive:

- ▶ For interventions 2 (10 000 LKR or 88 USD) and 3 (20 000 LKR or 175 USD), 17 to 22% of the firms that received a treatment offer registered before the end of the experiment (the difference between these two groups was not significant).
- ▶ For intervention 4 (40 000 LKR or 350 USD), 48% of the firms that received a treatment offer registered before the end of the experiment.

The remaining firms in the 40 000LKR category (350 USD) were approached and asked why they hadn't registered. Most of them reported to have started the registration process, only to find out that they needed the permission of their land owner, often the government.

This qualitative finding is confirmed by quantitative data, showing that formalization is much lower (significant at  $p < .01$ ) for firms operating on public land. No statistical differences were found between firms in different industries or locations.

The research team also controlled for alternative explanations to formalize, such as lack of knowledge, wealth of the company or risk-seeking individuals, which all proved to be not statistically significant. In terms of factors that are associated with the likely future costs of formalizing, expectancy to grow to 15+ employees has a negative effect (statistically significant at  $p < .05$ ).

### **The effects of registration on firm performance measures**

After the experiment was conducted, the research team first of all controlled in the two years that followed whether their intervention has had a statistically significant effect on survival of the firm, which does not seem to be the case.

The study performed additional analyses to find an effect of formalization on the performance of the firm. The results show a statistically significant positive effect on the profitability of firms. This positive effect is primarily caused by a handful of firms that have experienced large increases in profits. More qualitative analysis of this handful of firms shows a genuine change in business operations, which however does not offset the lack of improvement after formalization by most other firms. On other indicators of business performance (amount of sales, number of employees), no statistically significant effect was found.

Additionally, a two-wave annual survey was conducted in the two years after the experiment among the targeted firms. Many firm owners answered that they did not see the benefits of registration (36% of registered firms). Some firm owners however answered that it was beneficial for the image of their firm (20%), or reported to feel more secure

and protected. 10% claimed that it may help to obtain a loan, very few however report to actually have obtained a loan or government contract as a result of formalization. It should however be noted that it is not really surprising that only a few enterprises actually obtained a loan. Because only a minority of small enterprises in general – also in developed countries – are really ambitious and growth oriented and hence in need of external finance to further develop and innovate.

### **Attitudinal impact of formalization**

In the literature some evidence exists on the effect of formalization on attitudes, and therefore de Mel et al. (2013) included some attitudinal questions in the follow-up survey as well. More specifically, they asked about attitudes of firm owners towards the government, courts and police and towards taxation in general.

A very strong (statistically significant at  $P < .01$ ) effect of formalization was found for trust in local and provincial government, exactly the levels of government where the firm owners interact with for their registration. No statistically significant effects were found for the other variables. As such, the research team concludes that the process of formalization may be a powerful tool for attitude change, by showing firm owners that their government can in fact be trusted.

## **9.6 Lessons learnt and conclusions**

First of all the researchers argue that their findings may also apply outside Sri Lanka, as in different countries the same issues have been shown to be important.

For Sri Lanka, this study showed that prior to intervention owners of unregistered firms were either ignorant of the costs of registration, or vastly over-estimated these costs. However, simply informing them about the costs is not sufficient to induce registration of firms. An abolishment of the costs of getting registered (which is the equivalent of treatment group 1, where firms got the registration costs reimbursed) is also not enough to motivate informal firms to get registered at the divisional level. Only if registration results in additional benefits (in the form of additional payments that occur in treatment groups 2–4) are firms more likely to register themselves.

Higher benefits result in higher registration rates. Payments comparable to 2 months profits (comparable to treatment group 4) may lead to a registration rate of approximately 50%. In fact, in many cases where registration did not follow, this was due to practical constraints, in this case the requirement of approval of the landowner. The equivalent of 2 months of profits is not very high; De Mel et al. (2013) therefore conclude that “modest increases in the perceived benefits of being formal could be expected to dramatically increase the demand to formalize among firms currently operating informally” (page 148).

At the same time, the benefits of formalization appear to be relatively modest. An increase in profits is generally found, but this can be attributed to only a handful of firms. Refraining from formal registration of their firm thus seems a rational decision. On the other hand, the study shows that formalizing a larger number of firms offers clear broader societal benefits, in terms of higher trust in relevant government agencies.

# 10 Conclusions from the case studies

As mentioned in the introduction to this report, governments across the world want to reduce the size of the informal sector, because of many negative aspects that are associated with informal enterprises both at macro level as well as at micro level, e.g. poor labour conditions, a poor tax basis and poor coverage of social protection. One of the ways to reduce the size of the informal sector is by stimulating the formalization of informal enterprises. To support governments in the design and implementation of their strategies regarding the formalization of informal enterprises, ILO and GIZ want to verify what is actually known about what works and what doesn't. With this aim, this final chapter lists several observations and provisional conclusions in two sub sections.

## 10.1 Lessons learnt from selected cases

### Case 1 Monotax, Argentina

The Monotax scheme involves a simplification of the tax system for small enterprises. These are the main conclusions after analysing the Monotax regime:

- ▶ The scheme has a great ability to incorporate enterprises into the formal system that based on their size and characteristics have a high propensity to informality.
- ▶ The simplified regime covering the former obligations of the VAT and Income Tax and Social Security contributions, resulted in being inclusive: reaching a large volume of small taxpayers a.o. by offering health coverage and pension protection.
- ▶ The Monotax system also shows some weaknesses. Sometimes the Monotax is for example used for registering workers that actually should be registered as employees under a labour dependency relationship; in other words, employers make their employees register as if they were self-employed under the Monotax system to assess the benefits offered.

### Case 2 SIMPLES, Brazil

- ▶ Firstly, this case shows that the decision to formalize or not is mostly taken during the start-up of an enterprise. This suggests that policies to promote the formalization of enterprises may be more effective if they focus on the start-up phase.
- ▶ The SIMPLES case shows that a programme that reduces the costs of being formal and that relates these costs to revenues rather than payroll contributions can have significant positive effects on the degree of formality.
- ▶ Becoming formal, in turn, increases the likelihood that the enterprise will operate from a permanent location and hires paid employees. The finding that having a license to operate affects employment levels, suggests that the reduction in social security contributions plays an important role and the fact that – as mentioned with the previous bullet – fees to be paid are not related to the amount of wages paid.

### **Case 3 Individual Micro entrepreneur (MEI., Brazil)**

The programme addressed over 10 million informal entrepreneurs in Brazil, and it managed to register 1.4 million of them (nearly 14%).

- ▶ One of the main advantages is that the registration facilitates the opening of bank accounts, the application for loans and the issuing of invoices.
- ▶ Informality is a very important phenomenon in Brazil and must be approached with a set of integrated measures: provide adequate incentives for formalization, reduce information asymmetries in the informal economy and redefine the relationship between public institutions and enterprises and workers.

### **Case 4 Municipal reforms, Brazil**

The case showed that the opening of a Minas Fácil Expresso office in a municipality resulted on average in a reduction in registrations of about 10%. Two possible explanations for this negative effect of the reform are given:

- ▶ An initial negative impact might be due to necessary adjustments in the system before the new system runs smoothly.
- ▶ An additional reason might be that the new system unified municipal, state, and federal procedures. Before firms had the option of registering with only one or two of these levels of authority, thereby evading fees and taxes associated with the other levels. Although the system simplified registration procedures, the fact that the new system implied registering at all three levels of government may have resulted in fewer firms willing to register.

### **Case 5 Law 1429, Colombia**

This law of 2010 consists of a wide range of measures which, on the one hand try to improve the benefits of formality and on the other hand, are aimed at reducing the costs of formalization formalities. Some of the most important lessons learnt:

- ▶ Appropriate information and dissemination of the requisites and legal formalities that formal business must fulfil will reduce informality levels.
- ▶ The government implements excessively regulating mechanisms with the consequence that things become too complex and this discourages the creation of formal enterprises.
- ▶ The reasons why businessmen formalize their companies and employees are related to market requirements, rather than fear for legal penalties. In other words, the probability of penalties for micro and small enterprises seems to be low in comparison to the economic benefit they get from not fulfilling legal requirements.
- ▶ Measures aimed at formalization of enterprises, need to be accompanied by flexible support and counselling to enterprises in the process of formalization and to formal enterprises.

- ▶ It is important to modify the cost-benefit relation between formality and informality in the initial stages of the formalization process, so that formalization turns to be a real advantage for companies.
- ▶ Reinforce the compliance with the law, make justice more transparent, and reduce excessive bureaucracy.

### **Case 6 Experiment, Sri Lanka**

This case is about an experiment in Sri Lanka to offer financial compensation to informal firms if they decide to register. The main conclusions of this experiment are:

- ▶ Firm owners generally do not know the facts related to registration, such as actual costs or process length.
- ▶ However, informing them about the actual costs is not sufficient to induce registration of firms.
- ▶ Owners are only induced to formalize when the information is combined with incentive payments that are sufficiently large, i.e. payments comparable to 2-months profits.
- ▶ In many cases where registration did not follow, this was due to practical constraints such as the requirement of approval of the landowner.
- ▶ This study shows formal registration to be primarily a rational decision. Financial payments have an effect on registration, even when perceived benefits are relatively low.
- ▶ That governments should increase the perceived benefits of registration.
- ▶ Formalizing a larger number of firms offers broader societal benefits, in terms of higher trust in relevant government agencies.

## **10.2 Overall conclusions**

In Section 10.1, only main lessons per case are provided because the cases considered here are not providing a representative overview of all formalization efforts in different continents.

However, considering not only the six selected cases, but also general literature studied, some provisional overall conclusions can be listed in addition to the ones mentioned in Section 10.1.

For example the analysis of business environment reforms in various countries of Klapper & Love (2010) as described in Section 3.4 did result in several useful conclusions. Also a recent review of empirical studies by Bruhn and McKenzie (2013b) present useful findings. They look into the extent to which business regulations are indeed barriers to firms becoming formal and whether lowering such barriers have succeeded in bringing informal firms into the formal sector. Secondly they look into the extent to which being formal benefits these small enterprises. The main conclusions from Klapper & Love (2010) and Bruhn and McKenzie (2013b) can be summarized as follows:

- ▶ Some authors view the formalization of enterprises as a process, where the decision to formalize depends on the growth and age of the firm (Ishengoma and Kappel, 2006). However, several empirical studies suggest that the majority of enterprises make the decision on being formal or informal only during the start-up phase (La Porta and Shleifer, 2008; Fajnzylber et al., 2011). This suggests that policies to increase the share of formal enterprises should mainly focus on the start-up phase.
- ▶ The effect of business entry reforms on the number of firm registrations. One out of three studies considered by Bruhn and McKenzie (2013b) shows an increase in business registrations by 5 per cent because of opening one stop shops in major cities. Bruhn (2011) shows that this increase is mainly due to previous wage earners opening new enterprises. This suggests that, rather than stimulating the transformation from informal to formal, one stop shop initiatives succeed in increasing the share of start-ups that decide to become formal.
- ▶ For single reforms, reduction of payment has to be at least 50% to have a significant effect on the number of registered businesses. Reforms reducing the length of the procedure with 15% already lead to a significant change, the optimum reduction in length is 20%-40%.
- ▶ For capital requirements a weaker effect on business registration was found, still a reduction of 40–50% has a significant impact on business registration.
- ▶ Looking at several reforms combined, reducing for instance both the length and payments of registration, less drastic reductions are required because of the synergistic effect.
- ▶ A slightly stronger effect was found for reforms that were combined in the same year, as compared to sequential reforms.
- ▶ It is also shown that countries with weaker business environments require significantly larger reforms in order to influence business registration. This may be related to the fact that such countries have fewer benefits of formal sector registration; therefore larger reductions of costs are necessary to make registration worthwhile.
- ▶ One type of studies reviewed by Bruhn and McKenzie (2013b) has the same focus as the present report: 'effect of business entry reform on formalization of informal firms'. This group of studies contains two cases. The first is again one-stop-shops in urban areas in Mexico showing that some informal business owners become wage workers due to the reform, some register their informal business, but these effects are small. The second case on municipal licensing reform in Peru finds that the reform increased the number of provisional licenses issued to informal firms, but many firms don't renew their license later on.
- ▶ The last category of studies considered by Bruhn and McKenzie (2013b) concerns the effect of information, waived costs and enforcement on formalization of informal firms. Four cases are listed: (1) Peru: subsidized cost offer led to 10 to 12% of informal firms obtaining a municipal license; (2) Brazil: information and waived registration costs had

no effect on the formalization rate, municipal inspections increased the formalization rate by 22 to 27 percentage points; (3) Sri Lanka: Information and cost reimbursement had no effect on formalization rate. The experiment also showed that if much higher amounts are paid – comparable to up to two months median profits of the enterprises concerned – a considerable effect on the number of registrations does occur<sup>50</sup> (4) Delivering brochures with information to informal firms in Bangladesh had no effect on the formalization rate.

Considering all, the following can be observed:

- ▶ Success of reforms is context specific, as the definition and the characteristics of “the informal sector” can greatly differ from one country to another. Therefore there is a need to analyse the informal sector, for example to carefully determine to which extent one is dealing with ‘necessity entrepreneurs’ or ‘opportunity entrepreneurs’ before designing the reform agenda with specific policy measures.
- ▶ It is important to carefully look at the costs of formalization, e.g. the direct costs in terms of time to be spent on formalities (compliance costs) and fees and taxes to be paid. But this is not sufficient in most cases, one should for example also look at the extent to which the entrepreneurs in the informal sector are properly informed on the steps to be taken to formalize their business and the consequences it will have etc. And in addition to the costs, also the benefits of formalization for enterprises should be determined and communicated to allow entrepreneurs to get a better idea of the cost-benefit ratio.
- ▶ Also innovative tools to increase formalization could be considered such as a lottery with free tickets for those having paid taxes.
- ▶ When formalization is the policy goal, one should not only look at registration procedures, fees and taxes to be paid etc. Linking formalization to relatively easy access to social protection for entrepreneurs and workers in micro enterprises may be an effective tool.
- ▶ Overall there is a lack of data and evaluations that convincingly relate good practice examples to the actual number of enterprises being formalized as a result (casual effects properly analysed). When actions are taken, reforms therefore need to be monitored carefully and for a considerable length of time to see to which extent intended results are actually achieved. Only then will it be possible to determine good practices in the future.
- ▶ Finally, a necessary condition for any policy to become a good practice is that the policy must be implemented correctly and run by competent staff. It has been suggested that government officials should “change their arrogant behaviour towards those in the informal sector. Government officials may need to be sensitised to the importance of the informal sector” (Ishengoma and Kappel, 2006).

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<sup>50</sup> This is the same case (experiment) as described in this report in Chapter 9.

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# Appendices

## Appendix 1: Methodology of the literature review

This appendix describes the set-up and operationalization of the literature review.

### Step 1: Identification of relevant search terms

The purpose of the literature search was “to review the recent literature concerning credible empirical evidence on the effects of policy regulatory interventions encouraging formalization of Micro and Small Enterprises (MSEs). The assignment is to identify and document case studies for such policy interventions that could subsequently be used to synthesise the key lessons learnt into a practical guide”.

The first step was to identify appropriate search terms that capture all relevant recent material on these subjects.

**Table A.1:**

Search terms used, by key elements from the Terms of Reference

Source: Panteia

	Key element				
	Informal sector	MSE	Policy	Evidence	Formalization
English synonyms	informal sector	MSE	policy	evidence	formalization
	informal economy	SME	programme	empirical	formalization
	informal enterprises	micro	intervention	impact	formal sector
		small	support	quantitative	
			initiatives		
			project		
Spanish synonyms	empresas informales	micro	programa	empírica	formalización
	sector informal	pequeña	apoyo	impacto	formalidad
	economía informal	PYME	intervención	cuantitativos	formal
			política	prueba	
			iniciativa		
			proyecto		

The primary objective was to be as complete as possible, i.e. to minimise the probability that relevant publications would be missed, because a certain search term was not included. As a result, the list of search terms included multiple synonyms for certain terms. It was agreed that the literature review would cover documents written in English as well as Spanish. Therefore, the search terms are specified in English as well as Spanish. The final list includes many different search terms, which are listed in Table A.1.

## Step 2: Selection of relevant sources

The literature search has been conducted within the following on-line sources:

- ▶ [www.ideas.repec.org](http://www.ideas.repec.org). The Research Papers in Economics (RePEc) database currently contains over 1.2 million research pieces, including working paper series from universities across the world and international organizations such as UNU-wider, OECD, ILO and the World Bank. The literature search would be restricted to articles, papers and book chapters from 2007–2012.
- ▶ [www.jstor.org](http://www.jstor.org). The literature search in Journal Storage (JSTOR) would be restricted to articles from 2007–2013, from the following disciplines: economics; development studies; political science; public policy & administration.
- ▶ <http://search.proquest.com/>. The database ABI/Inform contains, among others, various SME journals.
- ▶ <http://www.webofknowledge.com/>. This search engine covers over 12,000 of the highest impact journals worldwide, including Open Access journals and over 150,000 conference proceedings. The literature search was restricted to articles, papers and book chapters from 2007–2013.
- ▶ [www.3ieimpact.org/evidence/impact-evaluations](http://www.3ieimpact.org/evidence/impact-evaluations). The International Initiative for Impact Evaluation database includes literature on pro-SME interventions.
- ▶ [www.worldbank.org/reference/](http://www.worldbank.org/reference/). In particular, recent papers of the Financial and Private Sector Development Department of the World Bank may be related to our topic.

Whenever the search options of the respective source permitted, our objective was to apply a Boolean search methodology that would include all of the predetermined search terms (for example, by searching for informal enterprises OR informal sector OR informal economy) AND (programme OR support OR intervention OR policy OR initiative OR project) AND (empirical OR impact OR quantitative OR evidence) AND (formalization OR formalization OR formal sector).

## Step 3: Application of the methodology

We have explored the six databases mentioned above and have hereby set the time frame between 2007–2013 to only find recent articles. We aimed to make use of all search terms that were determined up front, by searching for them in the abstracts of the publications included in the databases.

Whenever a specific search resulted in an acceptable number of publications (no more than 200 titles), the titles and abstracts of these publications were read to filter out any papers that turned out to not be relevant. The remaining publications were saved. In case a search yielded an unmanageably large number of articles (more than 200 titles), we adapted the search terms in order to narrow down the results. Where the narrowing down of the number of results did not work out (i.e. still a very large number of articles), we chose instead to examine the first 200 results.

In case the amount of papers in the respective database was very small (for example in the Proquest database), we chose instead to explore the website manually, thereby, identifying the most relevant articles.

Regarding the search based on Spanish synonyms, the proposed methodology did not find many relevant documents. These search terms were therefore also used in a more general search based on the Google search engine.

Finally, we included all papers and publications mentioned in the Terms of Reference that had not been identified through this systematic literature review. This included a large set of documents that were obtained during a previous ILO project<sup>51</sup>. A few of them were not relevant for this project, but the large majority was. We also included any additional suggestions received from ILO during the literature search phase.

#### **Step 4: Final selection of relevant papers**

The previous steps yielded a total of 123 publications. The final step in the search methodology approach consisted of reading the full text of these publications. We then constructed a database with bibliographical information, context information (country or countries covered by the study) and various indicators regarding the content of the publications. For example, to determine the type of programme evaluated, we registered which (if any) of the nine instruments involved are present in the programme. This was done for most of the identified publications, with the exception of seven publications that turned out to be thesis dissertations. For pragmatic reasons, we did not read these dissertations (as a result, they are not used as a potential case study source).

After these searches were done in English and Spanish literature a total number of 123 publications were identified (See Table A.2 for more details). During a first quick assessment these publications were described in terms of:

1. Authors, title and year of publication.
2. Number of pages.
3. Publication status (published yes/no).
4. Source, e.g. working paper series, database as RePEc or JSTOR.
5. Organization, e.g. World Bank, OECD or ILO.
6. Countries covered.
7. Region, e.g. Latin America, Asia etc.
8. Whether the topic informal sector, informality was indeed covered (yes, no).
9. Ten types of policies based on the list of the Donor Committee for Enterprise Development (DCED) presented in Section 2.4: (1) Business registration and licensing; (2) Taxation policy & administration; (3) Social protection; (4) Land ownership & titling; (5) Judicial reform; (6) Intellectual property rights; (7) Financial services; (8) Access to

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<sup>51</sup> This included almost 40 documents.

information about business regulation & rules; (9) Incentives for reform & communicating these to informal enterprises; (10) Other policy, type not listed by DCED, 2011.

10. Whether the publication describes results from these policies (yes, no).
11. Whether the publication describes these results in a quantitative way (yes, no).
12. Whether the publication provides credible empirical evidence (yes, no).
13. Whether the publication contains lessons learnt (conclusions) (yes, no).

After the assessment described below was completed, two additional columns were added:

14. Extent to which the publication seems to be suitable for the current study.  
An overall score given by the researchers on a scale from 1 to 5 for suitability from 1=not to 5 = very good.
15. Any additional remarks.

Table A.3 presents an overview of the identified publications, by type of instrument involved and region. Latin America is overrepresented in this selection and accounts for 32% of all identified publications. This is partly explained by the fact that studies on Latin American countries were already overrepresented in the set of documents provided by the ILO. A considerable group refers to studies where programmes from different countries are compared (28%). Of the studies that are restricted to a single country, a small group of seven countries<sup>52</sup> accounts for 60% of these studies. Please note that the table needs not to add up, because an evaluated programme may include various policy types.

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<sup>52</sup> Argentina, Brazil, Colombia, New Zealand, Singapore, India and Korea.

**Table A.2:**  
Identified publications, by  
instruments involved and region

Source: Panteia

Instruments involved	Region						Total
	Latin America	Sub-Saharan Africa	South-east Asia	Asia remaining	Other regions	Country comparisons	
Business registration and licensing	15	2	2	1	1	16	37
Taxation policy and administration	25	3	1	1	2	23	55
Social protection	10	3	1	2	0	15	31
Land ownership and titling	1	1	0	1	0	4	7
Judicial reform	9	4	0	0	2	10	25
Intellectual property rights	0	0	0	0	1	2	3
Financial services	5	5	2	3	0	11	26
Access to information about business regulation and rules	3	1	1	1	0	17	23
Incentives for reform & communicating these to informal enterprises	1	2	1	1	0	9	14
Other	2	2	0	2	1	8	15
Thesis dissertation	1	2	0	2	1	1	7
Total number of publications	39	13	7	14	15	35	123

Note: South-east Asia includes amongst others six studies from Singapore; Asia (remaining) includes amongst others five studies from Korea, five studies from India and three studies from China; Other regions includes amongst others eight studies from New Zealand.

Based on the content of these publications<sup>53</sup>, we established whether each paper would provide an adequate answer to one of our research questions. Hereby, the main criterion was whether the paper had a solid empirical base, implying the following:

- ▶ described results from one or more of the nine described policies.
- ▶ described these results in a quantitative way.
- ▶ held credible empirical evidence.
- ▶ contained lessons learnt.

Based on the number of criteria that were met (and the first impression of the quality of the study performed) we judged the suitability of each publication on a scale from 1 (not suitable) to 5 (very suitable).

<sup>53</sup> Excluding the seven identified thesis dissertations.

We identified 10 publications with a 'suitability-score' of 4 or 5. Table A.3 provides an overview of the distribution of these key publications according to the region and the type of instruments involved<sup>54</sup>. This time the distribution across regions is even more skewed. On the one hand, about 20% of the publications from Latin America received a suitability-score of 4 or 5. This results in eight key publications from this region. For the other regions, however, only 2% of the publications (2 out of 84) received a similar score. We have no explanation for this large difference.

**Table A.3:**  
Identified publications with high suitability, by instruments involved and region

Source: Panteia

Instruments involved	Region					
	Latin America*	Sub-Saharan Africa	South-east Asia	Asia re-remaining**	Other regions	Country comparisons
Business registration and licensing	6	0	0	1	0	1
Taxation policy and administration	8	0	0	0	0	1
Social protection	3	0	0	0	0	0
Land ownership and titling	0	0	0	1	0	0
Judicial reform	4	0	0	0	0	0
Intellectual property rights	0	0	0	0	0	0
Financial services	2	0	0	0	0	1
Access to information about business regulation and rules	1	0	0	1	0	1
Incentives for reform & communicating these to informal enterprises	1	0	0	0	0	1
Other	1	0	0	1	0	0
Total number of publications	8	0	0	1	0	1

\* This refers to programs from Argentina, Brazil and Colombia

\*\*This refers to a programme in Sri Lanka

<sup>54</sup> The table needs not to add up, because an evaluated programme may include various types of instrument.

## Appendix 2: Definition of SMEs

Many official definitions of size classes are based on a combination of multiple indicators, dealing with the size of the workforce, sales volume and/or the amount of capital invested (IFC, European Commission). For statistical purposes, however, size classes are usually defined by only one indicator: the number of employees. Studies tend to distinguish between either two (small versus large), three (small, medium and large) or four size classes (micro, small, medium and large).

Together, the smallest size classes are often referred to as either SMEs or MSMEs. In developed economies, the definition of the SME size class tends to include micro enterprises. This is, however, not a universally accepted definition. The IFC, for example, explicitly differentiates between micro enterprises and SMEs.

Often, the smallest size classes are compared to the size class of large enterprises. The threshold that is used to distinguish the smallest size classes from the size class of large enterprises varies between countries and between studies. The most common upper thresholds are 100 and 250 employees, but many other thresholds are used, ranging from 50 (for example in Bermuda, Jamaica and Malawi) to 500 (for example in Canada, New Zealand, USA and Yemen) (Kushnir et al., 2010).

In this study, the focus is not on comparing the smallest size classes with the size class of large enterprises, but on studying formalization of enterprises. It can be assumed that this is for the large majority restricted to micro and small enterprises. Hence, this study focuses on these two size classes, the MSE size class. Also here, the thresholds of these size classes vary between countries. The most common thresholds appear to be: 1–9 employees for micro enterprises, and 10–49 employees for small enterprises (Kushnir et al., 2010).

For the purpose of this study, we will (have to) use the size class definitions as applied in the documents and publications that we will identify.

### Appendix 3: Informal enterprises in registers of the Statistical Office, example Trinidad

In 1996, the Government of Trinidad and Tobago was making attempts to improve the policy climate for the growth of the Small Business and Micro-enterprise sector. The European Union financed a programme implemented by the Small Business Development Company Ltd, SBDC from Trinidad & Tobago. One of the components of the programme was a Sector Assessment Study (SAS) in conjunction with a National Baseline Survey (NBS) of small and micro enterprises in Trinidad and Tobago (Van Elk, 1996). The survey has been organised and carried out in co-operation with the Institute of Social and Economic Research (ISER) of the University of the West Indies, St. Augustine.

After discussions with specialists from amongst others, ministries, the Central Bank, and the Central Statistical Office (CSO) it was decided to draw the sample from the Register of Business Establishments of CSO. From this register a sample of 3847 enterprises with 26 or less employees was selected. The sample has been stratified to sector, size and region to allow more precise estimates referring to the overall population (all businesses as registered with CSO). Only by size, a disproportional stratification was applied to allow having a sufficient number of relatively large enterprises to arrive at conclusions about this group also. Hence results were weighted before drawing overall conclusions.

Not all enterprises could be reached or agreed to participate. In addition questionnaires received were checked for consistency. Finally 2104 eligible interviews were available for analysis originating from the following sectors of activity: Petroleum, Manufacturing, Construction, Distribution, Personal Services and Other Services. More than 70% of the businesses interviewed are sole proprietorships, the very small firms among these not-incorporated firms tend to be very close to the informal economy. At the time it was also considered to be important to get information on the informal sector. The study adopted a definition based on various considerations and considering different evaluations used in the literature. Six criteria were used to single out informal enterprises. Table A.4 shows the numbers of enterprises from the sample that satisfy the various criteria.

The following results were found in this survey in Trinidad and Tobago (weighted results correcting for oversampling of larger enterprises)<sup>55</sup>:

1. Sector. Informal enterprises are especially underrepresented in sectors: petroleum, distribution and other services. Informal enterprises are overrepresented in personal services, and only a bit in manufacturing.
2. Size. Informal enterprises are especially overrepresented in enterprises without personal (only owner working).
3. Development stage of enterprise. In the study four development stages of business were distinguished. There is a strong correlation between development stage and informality: the lower the developments stage the more informal firms are overrepresented.

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<sup>55</sup> No results in terms of formalization are provided. This is one of the reasons why the case did not make to the final selection

4. Gender. A relation with gender has been established: female owners are more likely to have an informal business.
5. Age of owner. Younger owners are more likely to operate informal enterprises.
6. Ethnicity. In the sample people from African and Indian origin were identified. Compared to Africans, the number of informal businesses was much lower in the Indian sub-group.
7. Educational level. Also a relation with the education level of the owner was established, only in the lowest educational level informal businesses are overrepresented.

In other words these findings can be recapitulated as: weighed results show that 21% of all enterprises registered with CSO are informal. These informal enterprises show relatively often the following characteristics:

1. Sector of activity: personal services.
2. Smaller firms.
3. Lower level of development.
4. Female entrepreneurs.
5. Younger owners.
6. African owners.
7. Owners with low educational level.

**Table A.4:**

Enterprises qualifying for the six criteria 'informality' set.

Source: Van Elk (1996)

The enterprise should:	Number of enterprises qualifying, out of sample of 2104 unweighted
Not have any licence, permit or certificate to operate	502
Not be incorporated, e.g. sole proprietors and partnerships only (no legal entities separated from the owner(s))	1 775
Have a working owner	1 981
Have less than 5 workers	1 612
Not have more than 2 full-time salaried employees	1 504
Not have more than 2 part-time salaried employees	2 045
Applying all criteria simultaneously	384







