CENTER FOR INTERNATIONAL PRIVATE ENTERPRISE

OPPORTUNITIES TO REDUCE ECONOMIC INFORMALITY

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“THESE ARE ENTREPRENEURS; TREAT THEM AS SUCH.”

- HERNANDO DE SOTO

CONTENTS

1. INTRODUCTION

Most of the world has an informal, or hidden, economy working in parallel to the formal, or mainstream, economy. The informal sector produces goods and services outside of government regulation and without legal status or protection. It consists of all firms, labor, and activities that are not legally recognized, not officially recorded, and not embedded in the modern market economy.

A common feature of developing and even developed economies, informality raises consequential dilemmas. Entrepreneurs in the sector generally produce legitimate goods and services, yet do not enjoy legal status. The sector provides avenues for earning a livelihood that may not exist in the formal sector, yet it lacks social protections and inhibits growth. It exists outside the system of public institutions, yet it effectively undermines the system. Those in the sector are generally at a disadvantage when it comes to accessing financing, markets, and services, yet still they pose unfair competition to their formal counterparts.

In 1984 at the prompting of Hernando de Soto, the Center for International Private Enterprise (CIPE) began its search for solutions to transform informal entrepreneurship. De Soto, CIPE's first program partner, had the insight that the quality of the business environment affects the level of entrepreneurial opportunity. Ever since, CIPE's programs have addressed issues of institutional quality and the incentives and barriers to doing business. Today, the persistence of massive informality is closely associated with disparities in society and the disenfranchisement of many. Fortunately, policymakers and practitioners now possess a broad range of experience and tools to help deal with the challenge.

This issue brief presents methods to expand entrepreneurial opportunity while strengthening the rule of law. It offers guidance to all who seek a competitive business environment, a more inclusive economy, or private sector development in harmony with the provision of public goods. It is aimed at policymakers, business leaders, and advocates for the informal sector. Following an overview of economic informality, the brief shares lessons from past policies, steps to tailor a reform strategy, and promising options for targeted solutions. Five miniature country case studies illustrate progress and lessons from reforms to taxation, registration, inspections, and more.

2. SCOPE OF THE CHALLENGE

The informal economy accounts for as much as 40% of GDP in many less developed countries.[1] It makes up anywhere from 51% to 82% of total non-agricultural employment in Latin America, Sub-Saharan Africa, and Asia.[2] Although they are numerous, informal businesses are excluded from accessing many market opportunities and public services.

A diverse range of enterprises operate outside the formal economy (Table 1). They differ in their size, status, and productivity. While micro enterprises make up the greatest number of firms within informality, small and larger firms are also engaged in informal activity. Therefore, informality does not fully equate to micro enterprise. While unregistered firms clearly are informal, registered firms also can be non-compliant with tax laws and business regulations. Moreover, a portion of a firm's activities may be formal while the remainder are informal. Thus, there is a continuum of compliance and non-compliance with formal regulation.

TABLE 1. TYPOLOGY OF INFORMAL ENTERPRISE

Informal			Formal	
Subsistence (micro) enterprises	Unofficial enterprises		Official enterprises	
Not registered	Not registered	Registered, not complaint	Some undeclared sales & workers	Compliant

Source: Adapted from Djankov et al., 2002[3]

CONSEQUENCES OF INFORMALITY

Informal businesses have limited access to mainstream economic opportunities, such as acquiring customers and formal credit. Most are less productive than their formal counterparts. (This may also be a reason for informality). Lacking rights to public services, they are constrained in their ability to enforce contracts, access utilities, or benefit from business support services.

Markets are encumbered by an inefficient allocation of resources to unproductive activities that persist in the informal sector. Formal businesses are handicapped by the unfair competition of businesses that do not pay tax. Overall, when a country's economy revolves around relationship-based transactions, the country is less competitive globally.

Workers in the informal sector lack social protection, especially insurance and pension benefits, and face inferior working conditions.

Governments have revenue reduced by hidden economic activity, and consequently are less able to provide public goods.

Rule of law is compromised by undeclared economic activity and non-compliance. Governments cannot effectively address health, safety, and environmental risks that occur outside the regulated economy.

Can these consequences of informality be reversed? It has been shown that opening routes to formality allows entrepreneurs to benefit in ways that include: having a fixed location, acquiring new clients, increasing investment, increasing revenues and profits, and increasing employment.[4] Many firms will never formalize, but those that do see significant benefits.[5]

3. SOURCES OF INFORMALITY

Globally speaking, the top sources of informality are, in order: tax and social security contribution burdens, intensity of regulations, poor public service provision, and trends in the official economy.[6] Less developed countries have larger informal sectors, and poor individuals with low human and physical capital are more likely to work informally.[7]

Taxation

High taxes create a strong incentive to keep production and employment hidden from the authorities.[8] Tax evasion is partly driven by low trust in public institutions. People are more likely to evade taxes when they feel that tax money is not well spent and that public services are not forthcoming in return. They also shirk paying when they do not trust other people to pay their share.[9]

Complexity and inefficiency in the design and administration of a tax system raise the cost of compliance.[10] In Brazil, for example, it still takes a medium-sized business 1,501 hours to comply with tax obligations, down from as high as 2,600 hours.[11] Authorities must consider their own costs of tax administration. A heavy-handed approach of aggressive tax auditing can be counterproductive and may not be a cost effective way of increasing public revenue.[12]

Business Registration and Regulation

A combination of high fees and excessive procedures required to register a business can prevent a small business from becoming formal. Registration is just the start of regulatory requirements that a business must satisfy. These include permits and licenses, labor regulations, health standards, financial regulation, and then re-registration requirements. Barriers to exit, such as punitive insolvency laws, may dissuade a business from closing or from even starting in the first place.

For a given level of development, the more regulations a country has, the larger its unofficial economy will likely be.[13] This is partly a function of limited government capacity and the transaction costs that businesses face. What is worse, where governance is weak, increasing regulation creates opportunities for officials to extract rents from business.[14] The countries that have more efficient procedures and stronger institutions have smaller informal sectors.[15]

Institutional Quality

Underlying other factors that influence the level of informality is the quality of institutions. Countries with stronger institutions can accommodate higher levels of taxation and higher levels of regulation while maintaining low levels of informality.[16] Better governance is associated with higher rates of new formal firm creation, while corruption is associated with larger informal sectors.[17]

When the quality of public institutions is low, firms go underground to evade bureaucracy and corruption, and not only the statutory tax burden.[18] A "vicious circle" then results as informality increases the fiscal deficit, shrinks the tax base, and undermines public institutions and public trust. This encourages further defections to the hidden economy.[19]

Firm-Level Decisions

Sometimes, the costs of registering and operating a business are prohibitive; they exclude firms from becoming formal. In a number of countries, the costs of start-up procedures have historically exceeded annual per capita income. In other cases, entrepreneurs make a decision about whether or not to formalize. This decision depends on their incentives and what their business can afford.

In a favorable environment, owners of businesses that have growth potential will prefer formality. If, however, the costs of formality exceed benefits, owners will opt to remain informal. They weigh the costs of taxes and compliance against the costs of non-compliance, which are linked to monitoring and enforcement.[20] On the benefits side of the equation, they evaluate potential market benefits—such as access to customers and financing—and public benefits—such as security, infrastructure, and business support services.[21]

4. POLICY LESSONS

Decades of attempts to eliminate informality have shown that simplistic responses do not work. Simply enforcing compliance, in the absence of reform, displaces business, threatens livelihoods, and is not cost effective. In Peru for example, after more than a century of expanding regulations and occasionally violent evictions, street sellers continued to occupy new locations and operate outside the bounds of the law.[22] Although enforcement must be part of any solution, this narrow approach falls short.

A more balanced approach is to open pathways to opportunity and formality while facilitating compliance. Using a combination of "carrots and sticks," policymakers should aim to change the cost-benefit ratio of operating in the formal sector versus operating in the informal sector.[23] (Table 2) Reforms that make formality relatively more attractive and accessible can produce two types of positive outcomes: either new firm formation and growth within the formal sector or a shift of informal enterprise to the formal sector.

The benefits of formality (upper-right quadrant) can be increased through the provision of public goods (such as security and contract enforcement) and through measures to actively facilitate business support. The costs of formality (lower-right quadrant) can be reduced by lowering barriers to entry along with lowering fiscal and administrative burdens. The costs of informality (lower-left quadrant) can be increased through efficient monitoring and enforcement in order to discourage unfair competition and free-riding on public services.

Dealing with informality requires an integrated response. For instance, business registration campaigns that provide information and incentives for companies to register have made modest contributions yet have frequently fallen below expectations.[24] Reforms in business registration must typically be accompanied by other reforms. Thus, in Sri Lanka some firms were deterred from registering by their inability to demonstrate land ownership.[25]

TABLE 2. SHIFTING THE COST-BENEFIT RATIO OF INFORMALITY

	Informal	Formal
Benefit	Tax avoidance No regulatory burden	Access to customers Fixed location Ability to enforce contracts Access to finance Public services Business support services
Cost	Audits & fines	Taxes & compliance Registration fees Regulatory burdens Inspections Taxes on labor

Reforms must be significant enough to be credible. Reducing the cost and time related to registering a business does boost new firm registration but only if the reforms are large. In OECD countries, reforms that reduce registration costs by 50% increase new firm registrations by 19%. Reducing the time it takes to register a business by 50% spurs new registrations by 30%.[26]

Short-term incentives are inadequate to induce a long-term shift in business behavior. In a number of cases firms have formalized, only to fall out of formality again in subsequent years. This points to the need to generate genuine benefits from formality, to simplify renewal requirements, and to promote the ongoing viability of businesses.

Gaps in the implementation of laws are a chronic institutional problem. Kenya has yet to implement policies such as the Micro and Small Enterprise Act of 2012, which would address MSE needs, register MSEs, resolve conflicts, and improve working conditions.[27] Reforms on paper often differ from reforms in practice. In practice, business environment reforms are experienced very differently by firms of different sizes and across different parts of a country.[28]

Finally, the reality is that only firms with productive potential are likely to see much benefit from operating formally. Most micro-enterprises are too small to realize benefits from full registration. Consequently, "'pushing' all firms into the formal sector may not necessarily be feasible or good social and economic policy."[29] Policy would better prioritize larger informal firms to bring them within regulation.[30] However, a small fraction of small and medium-sized enterprises—called "constrained gazelles"—do show excellent growth potential and deserve positive attention.[31]

5. REFORM STRATEGY

There are multiple possible reform strategies because local conditions vary and informality is a broad phenomenon. In each economic and institutional context, policymakers and business support organizations should assess their own reform goals and devise a logic of reform that suits their goals and populations.

1. Identify the sources of informality

- Barriers to entry and exit
- Incentives to operate informally
- Disincentives to growth
- Limits on firm productivity
- Quality of public services and business support services
  - Tip: Obtain stakeholders' input to identify the issues.

2. Develop solutions that are appropriate to local context

- Target solutions according to strategic priorities and firm capabilities
- Conduct cost-benefit analysis of solutions
- Hold public hearings
  - Tip: Examine how formal policies fit with traditional or customary practices.

3. Advocate for and adopt legal and regulatory reforms

- Raise awareness about barriers and costs
- Communicate the benefits of reform
- Frame policy changes inclusively (with economic, social & fiscal perspectives)
    - Tip: Build on and celebrate what has worked before.

4. Support the implementation of reforms

- Improve administrative processes
- Build government capacity
- Apply technology to promote better services, efficiency, and compliance
- Address policy implementation gaps
    - Tip: Improve two-way communication and feedback between government agencies and the businesses that are regulated or supported.

6. SOLUTIONS

The menu of solutions below is based on evidence and expert recommendations. This is not a prescriptive checklist but rather a set of promising options to consider within a locally targeted strategy.

Tax systems

- Reduce excessive rates
- Ease compliance with tax obligations[32]
- Introduce E-filing systems[33] and encourage electronically traceable payments
- Enhance audit capabilities; emphasize detection over expanded punishments[34]
- Conduct high-quality, risk-based inspections[35]
- Negotiate tax arrangements with informal sector associations[36]
- Simplify taxes with a presumptive or single tax
- Provide relief for startups and microfirms; avoid distorting incentives and discouraging growth[37]

Business regulation

- Simplify administrative procedures; reduce the fees and time required to register a business and to obtain permits and licenses
- Move registration out of the courts; reduce or eliminate minimum capital requirements[38]
- Set up one-stop-shops for business registration[39]
- Introduce electronic business registration[40]
- Adopt standard application forms[41]

Public institutions

- Streamline legal and regulatory codes
- Build the capacity of public agencies, including through e-government initiatives
- Promote a service culture and high-quality services
- Expand participation in dialogue to increase trust in government[42]
- Make private property rights accessible to all citizens[43]

Business support services

- Share information on legal requirements of running a business; assist with the process of formalization
- Provide support services and training for small- and medium-sized businesses
- Facilitate access to markets through partnerships with formal companies[44]
- Provide new market opportunities[45]
- Target firms for financing on the basis of growth potential and capacity to formalize[46]
- Promote digital financial inclusion[47] and digital payments[48]

7. CONCLUSION

Creating paths to formality allows more entrepreneurs to benefit from a stable operating environment and access to markets, thus increasing their ability to invest and grow their businesses. Formalization is a path, not a magic wand that transforms firms by registration. It requires changes in opportunity structures and the integration of firms into formal systems, all of which takes time. It involves building institutions, building trust, and changing firm behavior.

Reform efforts of the past two decades have yielded a mixture of progress, setbacks, and many lessons. Too often, reforms have been wielded as blunt instruments that treat informal business as a problem and not as a livelihood. Other attempts have offered short-term incentives that do not alter the capacity and calculus of firms. While there is no universal formula to expand formal enterprise, the chief lessons are that effective reforms balance compliance with opportunity, integrate multiple tools, are significant in scope, and are implemented in a sustained manner.

Effective reform strategies have produced incremental gains. Policy advocates who want to shift the equilibrium should seek changes at the margin, instead of pushing back against the broad phenomena of informality and micro-enterprise. While reformers should learn from the past, they can also exercise creativity in employing a variety of technologies, enabling regulations, business services, and value chains that may be at their disposal. What works in each instance will differ, but one thing is certain. Finding opportunities for effective change will require giving informal entrepreneurs a voice in the process and building bridges to opportunity.

REFORM CASE EXAMPLES:

BRAZIL[49]

Introduced in 1996, the Integrated System of Taxes and Contributions for Micro and Small Enterprises (SIMPLES) reduced the required taxes and social contributions for micro and small businesses by up to 8%. The program also simplified tax compliance by consolidating five (later eight) federal taxes plus social security contributions into a single payment. Finally, social security contributions were de-linked from the number of workers and tied to sales as an incentive to employ workers formally. SIMPLES induced about 7% more firms to register and increased tax payments by 3.1 to 4.6%. Firms that became formal had 55-57% higher revenues and 45-49% higher profits. Those that registered appeared more likely to have a permanent location, aim for a larger scale of business, and extend formal contracts to workers.

SENEGAL[50]

Senegal has one of the largest informal sectors in Sub-Saharan Africa. In 2011, the Center for International Private Enterprise (CIPE) partnered with UNACOIS, the country's largest business association, the majority of whose 70,000 members are small and medium enterprises in the informal sector. UNACOIS determined that high tax rates and the complex tax code were among the main causes of informality in the SME sector. In fact, one of its main services was to intervene in court on behalf of members whose informal businesses were shut down or goods confiscated by the police. UNACOIS's national headquarters intervened in over 200 cases per year. With CIPE's assistance, UNACOIS developed recommendations on tax reforms for the SME sector based on a comprehensive consultation with members. Senegal's parliament included these recommendations in a streamlined tax code for SMEs that made tax rates more proportional to profit margins. As a result of the new tax regulations, informal operators reported a decreasing number of disputes with local authorities.

BENIN

Beginning in 2011, Benin's entreprenant program provided a number of incentives for micro-enterprises to formalize. Registration costs were abolished and the time to register was reduced to one business day. Businesses that received training and information on the registration process reported a 9.1 per cent increase in formalization.[51] Businesses that received additional training—on management and accounting skills and how to open a bank account—reported a 13 per cent increase in formalization.[52] The last group of enterprises, which received tax mediation services and help with tax preparation, reported the highest rate of formalization of 15.8 per cent.[53] A survey of 3,600 informal businesses showed that access to information, simplification of registration procedures, and reduction in the cost to register is not enough to encourage widespread formalization. Additional steps such as business training, help opening a bank account, and assistance with tax preparation lead to higher formalization rates.[54]

COLOMBIA

In 2010, Colombia passed Law 1429 on Formalization and Employment Generation, which offered tax and registration incentives. Enterprises with fewer than 50 employees qualified for progressive payments for registration and renewals; amnesty and a discount on back fees for registrations; progressive reductions in income tax; and reduced payroll contributions. These reductions were phased out over time for each company. By the end of 2013, 622,226 newly registering firms took advantage of the law's favorable tax and registration regime—generally firms with more than nine employees—generating about 595,381 jobs.[55] Even before the law was approved, chambers of commerce of Colombia started implementing business formalization programmes and in Bogotá the chamber helped formalize 7,134 businesses. Mostly small firms benefited from the law, few micro-enterprises benefited, and many were unaware of the law. The move to formalize was temporary for many firms, which did not re-register as required the next year.[56]

SERBIA

The USAID Business Enabling Project supported the Government of Serbia in implementing economic reforms, including labor law reform and inspections reform. Amendments to modernize the Labor Law helped to lower unemployment from 23.9 per cent in 2012 to 14.9 per cent in the first quarter of 2017. The amendments encouraged hiring by reducing the mandate for severance pay, allowing more flexible employment arrangements, and reducing other regulatory burdens to employers. Prior to these amendments, employers had to deal with rigid laws and procedures that made hiring risky and expensive. After the new Law on Inspections Oversight started inspections of unregistered businesses, more than 23,000 entrepreneurs registered. There were 22% more newly registered entrepreneurs per month in 2015 compared to the previous year. Informal employment dropped from 23.2% at the end of 2014 to 19.4% at the end of 2015. The reform, developed through public-private dialogue, changed perceptions of inspectors within the business community. In 2017, 81% of surveyed businesses said that inspectors were well trained, up from 62% in 2013. In addition, public trust in inspections improved (70% positive vs. 30% negative in December 2015, compared to 48% positive vs. 52% negative in July 2014).[57]

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ABOUT CIPE

The Center for International Private Enterprise (CIPE) is a non-profit affiliate of the U.S. Chamber of Commerce and a core institute of the National Endowment for Democracy. CIPE's mission is to strengthen democracy around the globe through private enterprise and market-oriented reform, fulfilling a vision of a world where democracy delivers the freedom and opportunity for all to prosper. Founded in 1983, CIPE partners with local business associations, chambers of commerce, universities, think tanks, and advocacy groups to advance democratic and economic reforms worldwide. Headquartered in Washington, DC, CIPE teams are active in over a dozen countries through field offices and representatives. In addition, CIPE maintains a network of more than 130 organizations spanning over 70 countries. A wide range of donors directly support CIPE's work, and CIPE regularly collaborates with other international development and democracy organizations to carry out joint projects.

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