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## **Economic Growth and Poverty: Does Formalisation of Informal Enterprises Matter?**

### **Abstract**

The informal sector (IS) plays a significant role in developing countries viz. the provision of employment, income and supplying ignored markets. However, working and employment conditions within the sector are still poor. Its expansion and changing structures have thus drawn the attention of scholars and international policy makers to the factors hindering its formalisation. Among the factors addressed are the high costs of formalisation and the lack of incentives for operating in the formal sector. A variety of approaches have been adopted by different stakeholders to overcome these factors. This paper assesses these approaches along with the factors related to informality-formality trade-off and the issue of formalisation as a solution for firms' growth. By focussing on the problems faced by informal enterprises and the literature which addresses the options for accelerating the formalisation of informal enterprises, the paper will briefly summarise the weaknesses of these approaches.

**Key Words:** Informal sector, small enterprises, formal and informal institution, cost of formalisation, informality, formality, poverty, economic growth

**JEL Classification:** L5, O17, O4, D2, E26, I3

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## **Zusammenfassung**

### **Wirtschaftswachstum und Arbeit:**

#### **Welche Bedeutung hat die Formalisierung informeller Unternehmen?**

In Entwicklungsländern spielt der informelle Sektor (IS) eine bedeutende Rolle für Beschäftigung und Einkommen sowie in der Versorgung ansonsten missachteter Märkte. Gleichwohl sind Arbeits- und Beschäftigungsbedingungen in diesem Sektor in der Regel schlecht. Angesichts der Ausweitung und Veränderung der Strukturen des IS fragen daher Wissenschaftler wie politische Entscheidungsträger nach den Faktoren, die seine Formalisierung verhindern. Hierzu zählen unter anderem die hohen Kosten der Formalisierung sowie fehlende Anreize dafür, im formalen Sektor der Ökonomie zu operieren. Um diese Hindernisse zu überwinden, werden eine Reihe unterschiedlicher Ansätze angewandt. Dieser Beitrag analysiert diese Ansätze und fragt nach den Faktoren, die für die Entscheidung zwischen Formalisierung oder Verbleib im IS ausschlaggebend sind sowie nach der Bedeutung der Formalisierung für das Wachstum eines Unternehmens. Auf der Basis der Analyse der Probleme informeller Unternehmen sowie der Literatur über die Optionen zur Beschleunigung ihres Formalisierungsprozesses werden abschließend die Schwächen der verschiedenen Ansätze skizziert.

## **Article Outline**

1. Introduction
2. The Informal Sector: An Overview
3. Barriers to Entry into the Formal Sector
4. The Informal Sector, Economic Growth and Poverty
5. Strategic Options: Accelerating the Formalisation of Informal Enterprises
6. Conclusion and Recommendation

### **1. Introduction**

The contribution of the informal sector (IS) to the economy and its expansion in the developing countries has drawn the attention of both scholars and policy makers. The sector plays an intermediate role linking formal sub-sectors to consumers (Mlinga and Wells, 2002). It supplies the low and middle income employees of the formal sector with products and services not offered by the formal sector. In 1998 the sector accounted for 40-60 percent of urban employment in Sub-Saharan Africa (SSA) (Xaba, 2002). In 1990 it supplied approximately 25 percent of urban jobs in Latin America, while in Asia it accounted for between 10 and 65 percent (Sethuraman, 1997). According to the employment structure of the IS, self-employment offers more jobs than wage-employment the former accounting for 70 percent in SSA, 60 percent in North Africa, 60 percent in Latin America and 58 percent in Asia (Becker, 2004). However, self-employment is sometimes referred to as a community of the

poor or non-dynamic sub-IS (e.g. House, 1984; Djankov, 2002). This has triggered concerns among policy makers regarding the status of the IS and its relation to increasing poverty (ILO, 2004).

Apart from the aforementioned contributions, working conditions and income levels in the IS are still low and thus trap the actors in poverty. The hindrances to the growth of informal enterprises most frequently identified include: intra-firm factors – limited human and working capital,<sup>1</sup> poor location and the utilisation of obsolete technology; external factors – limited access to market, financial and business support services, complex and burdensome government regulations, a lack of economic infrastructure and a poor supply of public services;<sup>2</sup> and inter-firm factors – exploitative linkage relationships (Tokman, 1978; Gerry, 1978), limited forward linkages (Kappel et al., 2004; Arimah, 2001; Adam, 1995), non-innovative networking activities (Barr, 1998) and weak IS business associations (McCormick, 1999).

Several studies have reported on factors that impede the formalisation of the IS emphasising the high costs of formalisation and the lack of incentives for operating in the formal sector.<sup>3</sup> Various approaches have been adopted by stakeholders in order to overcome these problems and this paper aims to assess these approaches and the factors related to informality-formality trade-off as well as the matter of formalisation as a solution for firms' growth. By deliberating over the problems faced by informal enterprises and the literature addressing the options for accelerating the formalisation of informal enterprises, the paper will briefly summarise the weaknesses of these approaches.

From this point the paper is organised into six sections: Section 2 conceptualises the informality of a firm and highlights factors hindering the growth of informal enterprises. Section 3 addresses barriers to entry into the formal sector with a special focus on the costs of formalisation and the opportunity costs of informality. Section 4 tries to associate informality with poverty and economic growth. Based on the views of scholars and donor and governmental initiatives, Section 5 describes measures taken to accelerate the formalisation process. Section 6 is a conclusion and offers recommendations.

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<sup>1</sup> The Planning Commission and the Ministry of Labour and Youth (1991).

<sup>2</sup> See Morrisson (1995), Arimah (2001), Kappel et al. (2004), and Klein 2003 on limited financial services; Yu (2002), Ishengoma (2005), and Morrisson (1995) on poor business location and high cost of utilities.

<sup>3</sup> De Soto (1992), Loayza (1997); Djankov et al. (2002), Levenson and Maloney (1998), IBRD/World Bank (2005), Jaeckle and Li (2003), and Ishengoma (2005).

## 2. The Informal Sector: An Overview

### Conceptualising the Informality of a Firm

What is the Informal Sector?

The term IS was first introduced by Keith Hart (1973). The informality of firms has since been described in relation to interrelated aspects: compliance with government regulations (viz. registration, payment of tax and adherence to labour regulations); size of the firm; firm-level resource endowment and applied technology (labour or capital intensive), location, the physical place of operation and the characteristics of workforce and ownership. Tokman (2001) defines the IS as comprising firms with limited ownership (i.e. self-employed) that utilise unpaid family members, domestic servants, less educated employees, and have less than five workers (including the owner). Loayza (1997) views the sector as a set of economic units that do not comply totally or partially with government regulations.

The descriptions of informal firms according to their size are not concordant. Some scholars (e.g. Arimah, 2001) apply a cut-off point of ten people and others five employees (e.g. Tokman, 1978). Furthermore, some scholars relate the IS to micro or small enterprises (MSE) without stating how small a firm should be in order for it to be categorised as informal (e.g. Mlinga and Wells, 2002; Anderson, 1998). Their views are based on the premise that the majority of firms in these size categories are not likely to comply with government regulations.<sup>4</sup> However, there are smaller, registered firms which have permanent locations and adhere to some government regulations<sup>5</sup> while not all large firms abide by every government regulation, particularly labour regulations (Mlinga and Wells, 2002; Tokman, 2001). Some firms can be defined as semi-informal, since they keep parts of their business informal (Djankov, 2002) and utilise casual/unrecorded contractual labour.

The reviewed studies utilised a limited number of attributes that are easy to empirically conceptualise. The definition of the IS with regards adherence to government regulations however, seems difficult to conceptualise. Since informality in developing countries cuts across all size categories, some scholars (e.g. Morrisson, 1995) prefer to use the term 'micro-enterprises' instead of informal enterprises, while others (e.g. Mlinga and Wells, 2002) avoid the definition of informal enterprises as far as compliance with government regulations and particularly labour regulations is concerned.

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<sup>4</sup> Several studies (e.g. Levenson and Maloney, 1998; Morrisson, 1995) reveal that the level of adherence to government regulations is positively related to the size of the firm.

<sup>5</sup> For example, some self-employed, small and micro-firms identified by authors (e.g. Tokman, 2001) as informal are registered by local and/or national authorities and pay taxes to them (Arimah, 2001) and some utilising paid workers have registered them with the social security administration (Levenson and Maloney, 1998; Morrisson, 1995).



Recent studies on the IS emphasise the consideration of IS heterogeneity instead of conceptualising informality in a dichotomous way (i.e. formal or informal) which gives little insight into the sector. They report that not all firms categorised as informal follow the survival strategy. Indeed, some comprise characteristics similar to those of small formal firms (Mlinga and Wells, 2002) while others utilise relatively modern/sophisticated technology and educated workers (Ranis and Stewart, 1999; House, 1984). Levenson and Maloney (1998), for example, report diverse levels of formality among firms in the IS. The following section discusses the classification of the IS.



#### Classifications of the Informal Sector

Through emphasis on the role of the level of establishment characterised by a firm's ability to compete, Mlinga and Wells (2002) organize the IS into three sub-sectors: the characteristics of established informal firms (e.g. investment in equipment, registration requirements, ability to compete with formal small firms for formal private clients) are similar to those of small formal firms; emerging informal firms; firms supplying labour inputs only. Table 1 contains this categorisation together with the following approaches to classification and shows, through the indication of the arrow, the potential of the firms to integrate into the formal sector.

Ranis and Stewart (1999) use the firms resource endowment (the average level of human capital, the level of development of the technology utilised) and marketing channels (i.e. selling directly to final consumers or to large buyers) to classify the sector as traditional or modern, the latter having relatively high resource endowment and linked to relatively large buyers. House (1984) considers the motivation of the entrepreneurs to start a business to be an additional aspect with which to classify the IS and identifies three sub-sectors: the intermediate/dynamic IS is more business-oriented and characterised by a relatively high average IS income, educated workers, and subcontracting arrangements with the formal sector; the community of the poor is subsistence-oriented and its characteristics are opposite to those of the formal sub-sector; the transitional sub-sector falls between the previous two sub-sectors. Meagher (1995) identifies three categories in the IS: the survival informal group whose actors have an income equal to that of informal wage labour; dependent workers operating as commissioned sellers; and genuine entrepreneurs who are part of the modern informal sector.

Djankov et al. (2002) categorise the IS as subsistence and unofficial enterprises based on the potential enterprises have to graduate into the formal sector. The former are characterised as possessing low potential, short-lived and experiencing higher failure rates while the latter, although engaging in some unofficial activities or using unreported employees, have relatively high potential, are modern/dynamic and are likely to be formally registered.

**Table 1: Informal sector typologies**

Attributes	Informal sector		Formal sector	Informal sector		
	Subsistence enterprises	Unofficial enterprises	Official enterprises	Subsistence enterprises	Unofficial enterprises	
				Traditional <sup>a</sup> /stagnant/ community of the poor <sup>b</sup>	Emerging <sup>c</sup> / transition <sup>b</sup>	Modern <sup>a</sup> /dynamic <sup>b</sup> / well established <sup>c</sup>
Degree of informality	100%*	High. Proportion of sales undeclared and workers not registered	Some proportion of sales undeclared and workers unregistered. May use outside the official purview (e.g. internet to deliver software)	High <sup>d</sup>	Mixed and specific to institutions <sup>d</sup>	
Types of activity	Single street traders, cottage/micro enterprises, subsistence farmers	Small manufacturers, service providers, distributors, contractors	Small and medium manufacturers, service providers, software firms	Labourer contractor <sup>c</sup>	Established contractors similar to small formal contractor <sup>c</sup> Manufacturing <sup>b</sup>	
Technology	Labour intensive	Mostly labour intensive	Knowledge and capital intensive	High labour intensive <sup>a,b,c</sup> Rudimentary equipment <sup>a,b</sup>	Relatively labour intensive <sup>a,b,c</sup> Modern equipment <sup>a,b</sup>	
Owner profile	Poor, low education, low level of skills	Poor and non-poor, well educated, high level of skills	Non-poor, highly educated, sophisticated level of skills	Low skills <sup>a,b</sup> Non-business oriented <sup>a,b,c</sup>	Relatively high skills <sup>a,b</sup> Business oriented <sup>a,b,c</sup>	
Markets	Low barriers to entry, highly competitive, high product homogeneity	Low barriers to entry, highly competitive, some product differentiation	Significant barriers to entry, established market/product niche	Sell to local/low income final consumers <sup>a,b,c</sup>	Some linkages with formal ones <sup>a,b,c</sup>	
Finance needs	Working capital	Working capital, some investment capital, supplier credit	Investment capital and working capital, letters of credit, supplier credit	Working capital <sup>a,b,c</sup>	Some investment in equipment <sup>c</sup>	
Other needs	Personal insurance, social protection	Personal and perhaps business insurance	Personal and business insurance, business development services			
						
	Least dynamic Completely informal		Highly dynamic Partially formal	Stagnant	Relatively dynamic	

\* In line with this observation, Morrisson (1995) reports that the majority of self employed people in seven countries surveyed were not registered and paid no tax.

<sup>a</sup> Ranis and Stewart, 1999; <sup>b</sup> House, 1984; <sup>c</sup> Mlinga and Wells, 2002; <sup>d</sup> Levenson and Maloney, 1998.

Source: Djankov et al., 2002.

## The Establishment and Growth of the Informal Sector

The establishment and growth of the IS is related to a number of factors including the following:

### Decline in Economic Performance/Non-pro-poor Economic Growth

It has been argued that when the economic growth rate of a region or nation declines, firms in the formal sector tend to contract by retrenching employees in order to cut-down their operating costs (Ranis and Stewart, 1999). Retrenched workers then seek alternative sources of income, which mostly turn out to be informal businesses (Tokman, 2001). The expansion of the IS and the deteriorating employment situation in many developing countries in SSA, Latin America and the Caribbean are associated with low GDP growth rates (ILO, 2004). Many of these countries have also faced high population growth rates and increasing numbers of job-seekers particularly among the youth (see ILO, 2004; UNDP, 2001; Anderson, 1998).

However, an increase in the economic growth rate of a country does not automatically result in the movement of workers from the IS to the formal sector. Despite high GDP growth rates (over 7 percent) some East Asian countries have faced an increase in unemployment. In the 1990s China underwent the highest economic growth rate (GDP per capita annual growth rate of 9.5 percent) (UNDP, 2001) yet between 1996 and 1999 experienced a 28 per cent decrease of employment in state owned enterprises, a more than 50 percent decrease of female workers in urban collective enterprises and a 41 per cent increase of own-account workers and employees in micro-enterprises.<sup>6</sup> Similarly, Latin America experienced economic recovery and growth in the 1990s but it still faced an increase in unemployment (Becker, 2004). Based on these findings, Becker emphasises that economic growth may negatively affect the size of the IS only if it is pro-poor, meaning if it is accompanied by improvements in formal employment levels and income distribution.

### Rural-urban Migration

Between the 1970s and 1980s, the agricultural sector was the main area of occupation in most developing countries. In 1975, 79 percent of the population in some of these countries was to be found in rural areas. The fall in world market prices of primary products however, coupled with decreasing agricultural output, reduced agricultural income and increased unequal regional development in these countries; factors which contributed to the heightening of rural-urban migration. Between 1975 and 1999 the annual growth rate of the popula-

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<sup>6</sup> Ministry of Labour and Social Security, People's Republic of China (2002).

tion in urban areas of low income countries was 6 percent, higher than that of both rural areas (2 percent) and of the total population (2.2 percent).<sup>7</sup> Rising rural-urban migration augments the supply of low-skilled labour in the cities resulting in an expansion of the urban-IS due to the limited capacity of the formal sector to absorb job-seekers.<sup>8</sup> Indeed, a household survey on the Tanzanian IS indicates that the proportion of households engaged in the IS is higher in urban areas (around 56 percent) than in rural areas (15 percent in rural areas).<sup>9</sup> Besides rural-urban migration, the unsatisfied demand for services and products benefiting medium and low income earners in urban areas may explain the difference in the rural- and urban-proportion of households involved in the IS.<sup>10</sup>

#### Structural Adjustment Programmes (SAPs)

The implementation of SAPs has expanded the IS on account of the following reasons: the decrease of real wages in the formal sector (Anderson, 1998) has raised the cost of living, thus forcing household members (particularly women) to engage in the IS and supplement the households' income (Ishengoma, 2004). Furthermore, the privatisation of state owned enterprises has resulted in job-retrenchment;<sup>11</sup> while trade liberalisation has contributed to the contraction and closure of some formal enterprises which were unable to compete given the availability of cheap imports (Becker, 2004). As social security systems in the majority of developing countries are poor, retrenched people are forced into self- or wage-employment in the IS as alternative sources of income (ILO, 2004).

#### Disintegration of Production and Integration of Trade

Globalisation has led to the disintegration of production and the integration of trade, whereby global buyers are outsourcing some of their activities in labour advantageous regions. This has led to the retrenchment of workers (the majority being low-skilled) who had been involved in the activities being outsourced (Feenstra, 1998). In countries with poor social security systems, low-skilled retrenched workers are likely to be involved in informal activities. The increasing concentration of global buyers has strengthened their bargaining power but rising numbers of suppliers/producers in the upper part of the value chains have weakened their position. The increasing pressure applied by global buyers on producers to raise quality and reduce costs has resulted in the casualisation of their workers (Nadvi, 2004).

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<sup>7</sup> United Nations Development Program (2001).

<sup>8</sup> See Becker (2004), Anderson (1998).

<sup>9</sup> The Planning Commission and the Ministry of Labour and Youth (1991).

<sup>10</sup> See Anderson (1998) for the case of Mongolian urban informal sector.

<sup>11</sup> For example, in Mongolia between 1990 and 1995 employment in privatised industries fell by 50 percent (Anderson, 1998).

## Factors Hindering the Growth of Informal Enterprises

The factors hindering the performance of informal enterprises can be categorised as internal, external and inter-firm factors. Although several studies address the first two categories, the latter is not well covered which may limit initiatives taken to overcome the factors comprising the first two categories (Sethuramann, 1997).

### Internal Factors

The internal factors which hinder the functioning of informal enterprises include: limited human capital (the skills and motivation of employees), lack of working capital, the utilisation of obsolete technology and poor location. Regarding factors pertaining to human capital, several studies indicate that the majority of workers in informal enterprises are of low education. In the Tanzanian informal sector for example, 65 percent of employees were primary school leavers, while the majority of employers had higher than primary school education.<sup>12</sup> In terms of poor location, the majority of women-owned informal firms are home-based which may limit their expansion, interaction with other businesses, hence increased transaction costs and limited access to marketing information. Some informal enterprises operate in temporary physical structures, a situation that limits their access to public services: sanitation, water and electricity. The internal sources of funds/working capital are insignificant as the majority of informal firms (particularly subsistence enterprises) generate low incomes which are distributed between households and businesses.

### External Factors

*Access to financial services.* In developing countries, the majority of MSEs lack access to formal financial services. Between the years 1995 and 2004 only nine percent of informal enterprises in Jamaica and ten percent in Tunisia had access to bank loans (Morrison, 1995). Other African countries experienced similar circumstances for instance; only ten percent of informal firms in Nigeria and four percent in Uganda had access to bank loans (Arimah, 2001; Kappel et al., 2004). The firms accessibility to funds from micro-finance institutions was much lower (Arimah, 2001; Kappel et al., 2004). In Nigeria, funds offered by some MFIs were in a small way relevant for the subsistence IS but not high enough for profitable investments (Adam 1995). In Tanzania it appears to be more expensive to borrow from MFIs than formal financial institutions (Ishengoma, 2005).

The majority of economically vulnerable actors in the IS have no access to social and business security insurance services. This may trap them into risk minimising strategies related

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<sup>12</sup> The Planning Commission and the Ministry of Labour and Youth (1991).

to limited business growth (McCormick, 1999, Klein, 2003; Kappel, 2004). Moreover, the liability institutions that could protect entrepreneurs from loss in the instance of business failure are inaccessible to informal firms (Klein, 2003).

*Limited access to business development services (BDS).* Since informal firms do not comply with all government regulations the majority of them have no access to BDS offered/coordinated by governments. Some of these firms are unaware that BDS are offered in their locality while others are ignorant to their worth. It is also stated that BDS providers do not market their services to small and informal enterprises appropriately, assuming that these enterprises can not afford the services. It can also be the case that the services offered are of low quality or irrelevant to SMEs.<sup>13</sup>

*Limited market.* The majority of informal enterprises target the low income market because it is associated with low entry barriers. Enterprises in this market tend to compete for the same customers, a state of affairs which the majority of MSEs indicated as a major obstacle to the running of businesses in Uganda (Kappel et al., 2004). The magnitude of this hindrance is higher for those concentrated in one area as they tend to apply a copycat strategy and thus produce similar products. This limits their growth potential and stability and is one of the reasons why micro or informal enterprises experience a relatively high instance of downfall.

*Poor supply of economic infrastructure and public services.* The majority of informal firms lack a decent location for their businesses. Some of them are located in places with a limited supply or lack of public services and economic infrastructure (for example, water and electricity, transport systems, telecommunication systems, hygiene services). In comparison to residents/enterprises in middle or high-income communities, informal firms with access to these services incur a relatively high cost per unit for the service (Yu, 2002). On account of their small size they can not afford to invest in private public goods (Reinikka and Svensson, 2002) or to buy services from private providers which would be more expensive than sourcing from government suppliers (Ishengoma, 2005). A poor economic infrastructure and limited access to public services increases the operating costs of informal firms, limits their ability to meet quality standards (for example, hygiene standards in restaurants), hinders their participation in linkage relationships (Collier, 2000) and reduces their market and customer base.

*Complex and burdensome government regulations.* Conducting business in less developed countries is difficult due to complex and burdensome government regulations. These issues will be described in Section 4.

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<sup>13</sup> See [www.danishembassy-ghana.dk/documents/Component%203.pdf](http://www.danishembassy-ghana.dk/documents/Component%203.pdf).

### Inter-firm Factors

*The nature of linkage relationships.* The nature of the linkage relationships that seem to exist in developing countries is one whereby large, formal enterprises supply input to informal enterprises. These linkages are regarded as exploitative (Arimah, 2001). The forward linkages (i.e. informal enterprises supplying formal ones) while reported to have a positive effect on the performance of informal firms, are not very prominent in developing countries.<sup>14</sup> Even government organisations crowd out informal enterprises depriving them of their linkages with the private sector. Only 7 percent of informal business in Nigeria (Arimah, 2001) and 10 to 20 percent in Algeria, Tunisia, Thailand, Ecuador and Jamaica had access to the market for public procurement orders (Morrisson, 1995). Limited linkages between the formal and IS are among the factors that explain low competency in the IS, especially in the case of manufacturing firms which rely on an exchange of information and skills with the formal sector (Adam, 1995) given the insufficient supply of BDS.

*Governance structures.* As a result of the inadequate capabilities of the firms and their weak legal status, the majority of informal enterprises involved in bilateral vertical linkages with formal enterprises have relatively low bargaining power. Consequently they will likely be exploited (Tokman, 1978) and incur relatively high transaction costs. Gerry (1978) reported on the limited ability of Dakar's informal shoemakers to accumulate wealth and to grow; functioning under the dominance of monopolistic formal suppliers and buyers, they were squeezed from both sides. He asserted that when there are different layers of contractors such as original formal contractors, entrepreneurs (some of whom act as brokers) and labourers, firms in the first category accrue more profit by shirking their responsibility to cover social labour securities, whilst those in the last category are highly exploited.

*Weak associations.* Given the unlimited supply of labour, worker associations tend to have little bargaining power.<sup>15</sup> Family members working in informal enterprises however do not campaign for their rights, viz., the improvement of working conditions. This in turn may lead to the exploitation of informal workers by their employers, hence increased informality. Poor employment and working conditions also lessen the productivity of informal enterprises resulting in lower wages.

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<sup>14</sup> The Nigerian informal sector sources about 40 and 23 percent of material inputs and equipment from large domestic and foreign-based companies respectively; but its supply limited percentages to the formal sector (i.e. less than 10 percent) (Arimah, 2001). The percentages of informal enterprises that had subcontracting arrangements with large enterprises between the mid 1990s and 2000s is less than 10 percent in Nigeria (Arimah, 2001) and only 20 percent in Uganda (Kappel et al., 2004). House (1984) indicates a positive effect of subcontracting arrangements on the operating income of informal firms. Milinga and Wells (2002) emphasize the role of these arrangements in improving the management skills of informal enterprises.

<sup>15</sup> See [www.sewa.org/aboutus/index.htm](http://www.sewa.org/aboutus/index.htm).

### 3. Barriers to Entry into the Formal Sector

While some informal firms operate informally because they cannot meet the costs of formalisation, others (modern and transitional informal firms) operate partially or totally informally despite being able to meet some of the formal requirements (Mlinga and Wells, 2002). Modern and transitional informal firms appear to make a choice between formality and informality after having compared the costs and benefits of formalisation (Loayza, 1997; Djankov et al., 2002). When the costs of being formal are higher than the benefits, firms are more likely to operate informally and vice versa. Such firms also seem to choose the degree of participation and types of societal institutions based on the benefits they accrue from them (Djankov et al., 2002; Levenson and Maloney, 1998). The following sections address barriers to entry into the formal sector based on the cost-benefit approach.

#### Cost of Formalisation

Like De Soto (1992), Loayza (1997) categorises the costs of formalising an enterprise into formal entry and operating costs.

#### Entry Costs

When a firm decides to become formal, it has to be registered as a company and pay a licence fee. During the registration process the firm may undergo several procedures (viz., screening, health and safety certificates, registration with statistical offices, local authorities and respective ministries) in order to meet the official requirements. The number of procedures and the level of efficiency among the offices involved in the registration process differ from country to country. In East African countries the registration process entails 11 to 17 procedures, takes about 35 to 61 days, and costs between US\$ 194 and 339 (Table 2). In some Latin American countries the process involves 9 to 18 procedures, takes about 67 to 100 days and costs from US\$ 510 to 1,499. In transition economies the screening process involves 7 to 20 procedures and takes between 22 and 105 business days. The average number of procedures in the world is 6.26 (Djankov et al., 2002). In some developed countries the registration of a new business can be accomplished without involving many procedures and requiring only a small number of resources. In New York and Florida it takes approximately four and three-and-half hours respectively (Loayza, 1997). Inefficiency and corruption are part of the explanation for why less developed countries, despite their fewer resources, have more procedures – which are uncoordinated, more time consuming and require more resources – for



registering a business.<sup>16</sup> Besides this, high entry costs are among the reasons why less developed countries have a relatively large IS.

**Table 2: Number of procedures, time and cost for registering a new business**

Country	Number of procedures	Time (days)	Cost (US\$)	Cost (% of income/ GNP per capita)
<i>Sub-Saharan Africa*</i>				
Ethiopia	8	44	422	421
Kenya	11	61	194	54
Tanzania	13	35	557	199
Uganda	17	36	339	135
<i>Latin America*</i>				
Peru	9	100	510	24
Nicaragua	12	71	1,335	337
Bolivia	18	67	1,499	166
<i>Transition economies**</i>				
Azerbaijan	15	79		19
Belarus	20	105		16
Croatia	13	39		17
Georgia	12	48		39
Hungary	7	65		64
Romania	11	133		30
Kyrgyz Republic	9	22		15
<i>Western Europe*</i>				
Sweden	3	16	190	1
Denmark	4	4	0	0

Source: \* IBRD/World Bank, 2003; \*\* Djankov et al., 2002.

### Operating Formal Cost

Operating in the formal sector denotes the involvement of a firm in different societal institutions that entail the following operating formal costs.

*Time consuming.* In Peru an employee in the administration department of a small, formal firm has to spend about 40 percent of his/her working hours filling out government forms (De Soto, 1992).

*Burdensome and complex taxes.* Tokman (2001) reports that in Brazil micro-entrepreneurs have to pay at least ten different taxes and social insurance contributions, in Columbia seven, and eight in Peru. De Soto (1992) indicates that including tax, labour regulations, bureaucratic requirements and public utility rates it costs small manufacturing firms in Peru approximately 348 percent of after tax profit to operate in the formal sector.

<sup>16</sup> See De Soto (1992) for a case study on the requirements for the formalisation of a small textile business in Lima/Peru.

*Unaffordable labour regulations.* Meeting labour regulations involves cash outflows. In Peru full compliance with the labour regulations may result in a decrease of profit of over 50 percent. This deduction can affect 75 percent of formal firms which employ up to ten people (Tokman, 2001). In some countries labour regulations appear to be restrictive and costly. In India for example, when a woman who has been married for less than 12 months quits her job she has the right to receive a severance payment based on her years of service (IBRD/World Bank, 2005). It also costs the equivalent of 112 weeks salary to make a worker redundant. The majority of micro-enterprises interviewed by Morrisson (1995) in seven developing countries reported that the legal minimum wage is very high, the drawback being that it is fixed; with fluctuating returns, enterprises tend to avoid it.

*Cumbersome property registration and formal loan application.* Loan application requires the submission of registered assets as collateral and certified financial statements which necessitate the utilisation and payment of accounting consultancy fees. Property registration in the majority of developing countries is time consuming and costly involving 21 procedures in Abuja compared to only 3 procedures in Helsinki (IBRD/World Bank, 2005). Its complications and charges are, among other reasons, inflated by the domination of the informal exchange of properties as formal exchange is expensive. The process of acquiring communal land and an official building permit for residential or business premises takes almost seven years in Peru. Yet the ownership of land or premises does not give the owner the right to use them as collateral or sell them (De Soto, 1992). The complicated and high costs involved in property registration are partly responsible for the accumulation of "dead capital" which is inefficiently used to generate income. In Egypt dead capital (i.e. the value of investment in real estate) amounts to around US\$ 240 billion (De Soto, 2001).

*Inefficient contract enforcement mechanism.* Access to security and judicial services for contract enforcement is inefficient (Loayza, 1997), entails paperwork, a close follow-up and advice from lawyers; all of which call for cash payments. In developing countries the contract enforcement procedure is complex and sometimes involves corrupt government officials. In Jakarta it costs 126 percent of the debt value to enforce a contract, while in Seoul it is only 5.4 percent (IBRD/World Bank, 2003). In Guatemala it can take four years to resolve a commercial dispute in court and the outcome is uncertain.

### **Cost of Informality**

Operating within the IS is not without cost since actors in government institutions and the formal sector regard the IS as unofficial. The costs of operating in the IS are as follows:

Penalties and corruption

In most cases the detection of informal enterprises is accompanied by corruption, harassment and the confiscation by government officials of the enterprise's properties (products and assets). For the most part enterprises operate without assurance and have to budget for bribery. In Peru around 10 to 15 percent of an enterprises gross income goes towards bribes, while formal firms pay about one percent (De Soto, 1992). In transition economies informal firms can incur bribes of up to 20 percent of their revenue (Djankov et al., 2002). When government officials benefit from the formalisation process of informal enterprises (for example, by receiving bribes), they may in fact retard the formalisation process (Loayza, 1997).

### Informality Opportunity Costs

The opportunity costs of operating in the IS are as follows:

*Limited access to public services.* On account of their unofficial status, informal enterprises do not have full access to public services. They are poorly protected by the national security system and thus subject to many crimes (Loayza, 1997) and high transaction costs related to high opportunism from business partners; a situation that may force enterprises to trade with people they know, hence limited market and growth potential.

*Avoid profitable expansion.* The majority of informal enterprises do not expand or invest in modern equipment for they wish to minimize their visibility and avoid attention from government institutions. Remaining small may be the right decision if an enterprise operates in a cluster and manages to specialise in specific activities. However, the consequences of staying small include: the inability to enjoy economies of scale or increase efficiency and competitiveness. Additionally, invisibility implies avoiding profitable markets that can be accessed through public advertisements.

*Limited access to financial and BDS.* Informal enterprises face difficulties in accessing BDS and financial services whose provision requires legalised transactions (Loayza, 1997).<sup>17</sup> Besides this, financial institutions view MSEs as costly and risky. Credit and business promotion programs co-ordinated by government institutions also crowd out informal enterprise and as a result, these enterprises are forced to depend on informal sources of external financing which are sometimes expensive and of a short-term nature. Drawing on Huq and Sultan's (1991) results, Loayza (1997) reports that in 1988 Bangladeshi non-institutional sources of finance charged an annual interest rate of around 40 to 100 percent while commercial banks only charged about 12 percent.

*Limited possibilities to cooperate with formal enterprises.* The participation of informal firms in bilateral vertical linkages with formal ones depends on their degree of formality. Indeed,

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<sup>17</sup> As addressed by Levenson and Maloney (1998), one of the requirements of financial institutions for extending funds to business entities is their registration. On the other hand, the government asks the financial institutions to report the identity of their business partners for tax purposes.

partial formality (e.g. registration by the local authority) seems to increase subcontracting arrangements (Milinga and Wells, 2002; Arimah, 2001). A high degree of informality however may increase informality opportunity costs, such as lost benefits (viz., a reliable market, financial support, technology transfer training and supervision of production operations) from bilateral vertical linkages.

### **Informality – Formality Trade-off**

This section briefly summarises factors that may shape a firm's decision to operate formally or informally given formality and informality costs.

*Growth and age of the firm.* Levenson and Maloney (1998) view the formalisation of enterprises as a process; the entrepreneur decides to formalise the enterprise as it grows, since operating formally (i.e. participation in societal institutions) becomes important<sup>18</sup> and because some of the benefits derived by doing so outweigh the costs. On the other hand, access to informal societal institutions – social networks/relationships for implicit contract enforcement, informal capital market, family, apprentices and casual labour, a mutual extended network of friends and family for providing insurance for old age and health – may be sufficient for a relatively small firm. As a firm grows the provision of fringe and social benefits becomes indispensable for attracting good workers (Levenson and Maloney, 1998). In addition, the firm needs to use a legally recognised system for enforcing contracts with all (known and unfamiliar) business partners (Loayza, 1997) as the utilisation of informal societal institutions becomes insufficient, unmanageable and in all probability costly. However, the benefits of operating in the formal sector are only likely to be realised if the legal framework caters for the needs of MSEs, which is not the case in many developing countries (De Soto, 1992).

Regarding the age of a firm, it is argued that being young is associated with shorter life expectancy. Thus, younger firms (the majority being informal) may choose not to participate in all (or some) societal institutions due to the uncertainty surrounding their future (Levenson and Maloney, 1998; Jaeckle and Li, 2003).

*The line of business.* Jaeckle and Li (2003) argue that the line of business or sector in which firms are involved seems to determine their level of participation in societal institutions. They report that firms in the manufacturing sector seem to employ a relatively high number of paid workers and operate far from home; while firms in the resale sector utilise more unpaid workers, operate from fixed premises, are non-home-based and pay some taxes. Thus,

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<sup>18</sup> Societal institutions include federal and local treasuries, governmental programs such as social security (including pension and health care), the legal system, the banking system, health inspection, firm censuses, trade organisations, civic organisations and so on.

compliance with labour regulations seems important for manufacturing firms and less important for those in the resale sector.

*Priority societal institutions.* The literature on the participation of informal firms in societal institutions claims that firms appear to choose the institutions and the level/degree of participation with them based on the positive net benefits which they provide.<sup>19</sup> A study in Peru by Jaeckle and Li (2003) revealed that 22 percent of micro enterprises were registered with the national treasury, of which 71 percent paid some taxes. Fourteen percent of non-registered firms also paid taxes. Only 4 percent of those enterprises which had been in business for more than three years and utilised paid workers, paid indirect labour costs. A study by Levenson and Maloney (1998) on Mexican micro enterprises showed that 42 percent of them were registered with the federal treasury, 25 percent were registered with the local treasury, 35 percent paid some taxes and 35 percent of those with paid workers had registered them with the social security administration. Seventy percent of micro enterprises in Brazil and 57 percent in Chile made some contributions to labour benefits (Tokman, 2001). Morrisson (1995) reported that the majority of enterprises in Algeria with at least 5 employees, 75 percent of MSEs in Tunisia, and 40 percent of MSEs in Swaziland paid sales tax. Anderson (1998) discovered that more than 50 percent of micro-enterprises (taxicabs, kiosks and boot repair) in Mongolia are registered with tax authorities, between 13 and 40 percent are covered by social insurance, and between 36 and 51 are covered by health insurance.

*Knowledge of anticipated benefits.* The trade-off seems to apply to enterprises which have some knowledge of formality processes and the need to and benefits of participating in different societal institutions. Morrisson (1995) asserted that the majority of unregistered enterprises were not aware. ILO (2003) found that some employers and employees in the IS are ignorant of the implications of working and employment conditions.

*The level of enforcement exercised by governments.* In some cases (e.g. the hygiene and quality standards of small restaurants in Tunisia, Thailand and Jamaican cities) where inspections and sanctions (penalties or threats) are frequently made, the majority of enterprises tend to comply with regulations, which thus enables them to increase their returns. In other cases however, (e.g. the quality standards and working conditions in metal work and textile industries and labour regulations in the majority of enterprises) enterprises do not comply with regulations because of the lack of enforcement mechanisms. In addition to this, enterprises take advantage of the labour market situation and lack of participation by informal workers in unions (Morrisson, 1995; Bass and Kappel, 1997).

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<sup>19</sup> Some of the institutions are interrelated in that the participation in one may need that of another. For example, a firm may need to be registered in order to apply for external financing from formal financial institutions.

### **Is Formalisation a Solution?**

Given the current business/economic and regulatory environment in developing countries, the opportunity costs of informality seem to be much lower than the cost of operating formally. This is based on the premise that even small and medium enterprises (SMEs) with a higher degree of formality still face the same obstacles as those with a higher level of informality. On the other hand, the cost of operating formally is very high for formal, medium firms (Weder, 2003). This discourages MSEs to grow and increase their degree of formality. Furthermore, formal firms (particularly small ones) have neither continuous access to the economic infrastructural services (e.g. water, electricity, sanitation, telephone services, transport system), nor do they receive government investment incentives accessible to the large firms (Ishengoma, 2005). The inefficient provision of public and financial services leads to high transaction costs. Due to inefficient and poor property right enforcement coupled with corruption, most transactions among formal enterprises are coordinated by informal networks. Irrespective of their formality, SMEs and large manufacturing firms have limited access to long-term loans (Ishengoma, 2005).

Based on this discussion, total formality may mean closing up the business unless the business environment within which firms operate is improved.

### **4. The Informal Sector, Economic Growth and Poverty**

As explained in Section 2, the literature suggests that a negative economic growth rate may raise unemployment and poverty. People (mainly women, the disabled and the low educated) who are retrenched during economic recession, engage in the subsistence informal sub-sector. However, some retrenched people engage in transitional/dynamic informal MSEs and pursue an entrepreneurial career. Though these entrepreneurs do not belong to the community of the poor, some of their employees do.<sup>20</sup> Due to the fact that the subsistence informal sub-sector dominates employment in the IS and a significant number of employees in the dynamic and transition sub-sectors are poor, the majority of people engaged in the IS can be considered poor.<sup>21</sup> The following paragraphs briefly address the relationship between the IS and poverty as well as economic growth. The discussion disregards the direction of causality as it runs from both sides and among the three variables.

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<sup>20</sup> See Orlando (2001) on the average earnings of different categories of employers and employees in Venezuela.

<sup>21</sup> See House (1984). Cartaya (1991) cited in Orlando (2001) reveals that poor household members are either self-employed or employees in the informal sector. Orlando (2001) also indicates that the incomes of families in extreme poverty are mainly from the informal sector.

*The informal sector and poverty.* There are contradicting views regarding the relationship between poverty and the IS. On one hand, the IS seems to trap its actors in poverty while on the other, it contributes to the reduction of poverty. The IS offers jobs that are of low quality, have poor employment and working conditions and therefore do not contribute much to poverty reduction.<sup>22</sup> Among the working population, workers in the IS are poorly remunerated, underemployed, have no social protection; their rights are less respected, and they are excluded from social dialogue and decision making. Thus, workers in the IS run a high risk of injury and their health is harmed on a daily basis. In the event of injury or illness they have no protection or safety net to help them and their families survive on a reduced or cut-off income (ILO, 2003). Thus, it can be inferred that poverty forces people to engage in the IS and working in the IS means poverty.

By comparing some of the dimensions of employment and working conditions of the formal and IS, Orlando (2001) revealed that in 1991 and 1997 earnings per hour in the formal sector in Venezuela were 44 and 49 percent higher than in the IS, respectively. Looking at income dimensions of poverty the IMF (2004) reported that in Serbia and Montenegro the incidence of poverty, relative poverty risk, poverty depth and poverty severity are higher for people working in the IS (grey sector) than those in the formal one. The situation is even worse for female informal workers whose average earnings are 70 percent less than those of informal male workers (Orlando, 2001).

Contrarily to the view that associates the IS with sustained poverty, Anderson (1998) attempted an answer to the question: how would the poverty situation have looked in the absence of the IS? He revealed that in 1996, around 38 percent of households in Ulaanbaatar/Mongolia had a poverty-level income. In the absence of informal incomes, 53 percent of households would have fallen below the official poverty line, which attests to the contribution of the IS to poverty reduction.

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<sup>22</sup> There are three dimensions of poverty: income poverty includes indicators considering per capita income below the poverty line; subjective well-being poverty addresses the views of the people in relation to the life they lead, and capability poverty which includes physical functioning (considering health, literacy, investment/savings) and social functioning, which account for the ability to avoid shame, maintain self-respect, and participate in decision making for issues related to the society (see Kingdon and Knight, 2003; Habitat, 2000; Sethuraman, 1997; Nadvi and Barrientos, 2004; Sen, 1983). Habitat (2000) relates some of the issues addressed under physical functioning to poverty of access (i.e. lack of access to basic infrastructure and services: education, shelter, piped water, electricity, wastewater disposal and solid waste collection by government agencies and organisations). Their definition of poverty of power (i.e. lack of participation in decision making within the society) is slightly similar to inadequate social functioning. Nadvi and Barrientos (2004) introduce the concept of participation (i.e. poverty of participation) indicated by social and physical isolation, powerlessness and lack of voice, low social status and physical weakness. From the above description, the terms inadequate social functioning, poverty of power and poverty of participation, can be used interchangeably.

*Informal sector and inefficient fiscal policies.* As the majority of workers in the IS have no written contract, informal enterprises do not give accurate figures of their sales and incomes; the income and sales taxes collected therefore are lower than the appropriate amount. In Montenegro it was expected that the legalisation of 20,000 employees would increase fiscal revenue by EUR 10 million (IMF, 2004). The collection of taxes from informal enterprises is also costly. Tax administration in Peru costs 75 percent of the amount collected from the IS (Tokman, 2001). As a result, the fiscal revenues amassed by governments are low, a situation that limits their ability to offer a reliable and sustainable economic infrastructure and public services. Poor provision of these services increases transaction costs, reduces productivity, and raises capabilities poverty.

Beside the problems related to the supply side of the economic infrastructure and social services the demand side involves low utilisation of the services by the IS. The negative implication being a high fixed-cost per service offered, hence a low return on investment and an unsustainable provision of the services. Empirical evidence by Loayza (1997) revealed that an increase in the size of the IS in Latin America decreased economic growth since it reduced the availability of public services<sup>23</sup> for everyone in the economy and increased the number of activities that inefficiently use some of the public services.

*Formality as an input in production.* Scholars (e.g. Levenson and Maloney, 1998; Jaeckle and Li, 2003) who regard formalisation as the participation of firms in societal institutions view formality as a normal input in production determining therefore the level of output and growth. This can be addressed from different angles. Formalisation is connected to a higher possibility of access to productive resources and full utilisation of public services and the economic infrastructure. From the point of view of human resource management<sup>24</sup> formality, which implies respecting labour norms and rights, the participation of IS workers in decision making processes and good working conditions, are part and parcel of human capital (an input in the production process) and therefore have positive effects on productivity and income through increased worker motivation (ILO, 2003).

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<sup>23</sup> Economic growth is estimated according to the average growth rate of real per capita between the years 1980-1992. The provision of public services is done by proxy through an index of public infrastructure including: per capita electricity consumption, per capita telephone mainlines, access to safe water of population per capita, and roads in good condition per capita.

<sup>24</sup> See for example, Maslow's theory of motivation, behavioural management literature, and goal setting theory.



## 5. Strategic Options: Accelerating the Formalisation of Informal Enterprises

Measures for encouraging the formalisation of informal enterprises need to address: the factors hindering their growth, the increasing costs of formalisation, and discourage their participation in formal societal institutions. This section reviews and assesses the literature and measures taken by selected governments, donor agencies and non-governmental institutions to accelerate the formalisation process.<sup>25</sup>

### Proposals in Reviewed Literature

#### Reformation of Regulatory Framework

Morrisson (1995) emphasises the need for the reform of regulatory frameworks in accelerating the formalisation of informal enterprises. Starting with the registration process, he recommends that it should take at most two hours, require the minimum number of documents, and cost less than US\$ 2. Some scholars (e.g. Tokman, 2001; Becker, 2004) propose the need to have a one stop-shop which integrates all the procedures required for business registration in order to cut down entry cost, to avoid overlapping and contradictory regulations, and to facilitate the provision of information.

While Tokman (2001) addresses the need for the actors in the IS to adopt a business oriented attitude, Morriison (1995) highlights the need for government officials to change their arrogant behaviour towards those in the IS. To solve this problem, legislation which would recognise the IS, empower actors within the IS and create awareness which would enable them to demand their rights and deal with government officials' inappropriate behaviour, may need to be enacted (Becker, 2004). Furthermore, government officials may need to be sensitised to the importance of the IS.

Regarding labour regulations, the formalisation of informal firms may require dual/multiple labour regulations (i.e. specific regulations for specific informal sub-categories) so as to enable those who can meet part of the social contributions to do so instead of not complying at all or closing up their businesses and in that way increasing unemployment and poverty. Morriison (1995) addresses the need for dual minimum wage-legislation which would be structured in accordance with the size of businesses; informal enterprises may be subject to a lower minimum wage. He emphasises also the need for double safety nets for which micro-enterprises could pay certain percentages of social security funds (e.g. 5 percent) and states could cover the rest. He recommends this system because it has produced satisfactory results in Ecuador. India is also considering the implementation of dual wage-legislation in

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<sup>25</sup> Poverty alleviation strategies are also part and parcel of measures targeting the informal sector. However, they are beyond the objectives of this paper since it focuses on enterprises.

order to improve the effectiveness of the social security system (Becker, 2004). Tokman (2001) however, disagrees with this proposal as it may discourage business growth among micro-enterprises and government regulations may no longer treat workers equally. According to his views, common labour regulations seem the best option even in the absence of compliance capabilities. However, with a large percentage of non-compliance, atypical and precarious employment, workers are already unequally treated before the law.

As regards the fiscal system, Levenson and Maloney (1998) argue that the benefits accrued by firms participating in societal institutions are not homogeneous and thus, the payment of universal levies charged by governments might not be appropriate. Morrisson (1995) proposes that all taxes (except local levies) need to be merged so as to reduce the cost of collection and the disturbance to enterprises, while local levies may be transformed into fees for community resources, viz., marking location, equipped industrial plants and infrastructure. This, together with the involvement of MSEs in decision making processes in their communities may increase the accountability and transparency of local government authorities. He adds that the subsistence IS needs to be granted tax exemption for an agreed period and afterwards charged a lower flat rate for the subsequent period before graduating into a relatively higher income group.

#### Improving Access to Productive Resources and the Market to Informal Enterprises

Another way to increase the participation of informal enterprises in the formal sector is the reduction in the magnitude of factors that limit their growth (Becker, 2004; Tokman, 2001; Morrisson, 1995). Proposals include: the improvement of access for the IS to BDS and financial services.

Additionally, scholars (see Morrisson, 1995; Becker, 2004) suggest the enactment and improvement of legislation facilitating the accessibility of informal enterprises to productive resources. These include the efficient provision of property title deeds (IBRD/World Bank, 2005) which would be possible if the provision of title deeds recognised property ownership based on long-term use – given the informal exchange of properties (Tokman, 2001). Moreover, governments need to acknowledge informal popular rules for secure property rights (De Soto, 2001). De Soto argues that property rights have to grow from bottom up and this needs to be encouraged and taken up by governments as massive informality develops when the law fails to coincide with the way people live and work. The government of Sri Lanka has acknowledged this and already started to set up land titling and to provide legal tenure to families for the land they have lived and worked on (Becker, 2004). The provision of title deeds offers poor people the right to use their properties in efficient and legally secured market transactions (De Soto, 2001). This may enable them to relate freely to government and private businesses without fear and enjoy protection against uncertainty and

fraud. It may also encourage them to upgrade their properties. Indeed, without legal ownership, most assets are economically and financially invisible.

On the matter of business location, Morrisson (1995) emphasises that all business actors, whether in micro or large enterprises, should have equal chances to operate in good locations provided they abide by the rules governing these localities. Tokman (2001) suggests that informal enterprises (e.g. street vendors) need to be provided with permanent places for their activities in accordance with municipal regulations. He adds that such places need to be well served by the public transport system in order to enhance their markets.

#### Promotion of Informal-formal Sector Forward and Multilateral Linkages

When firms in the IS participate in bilateral vertical linkages with firms in the formal sector, they may benefit from a reliable market, financial support, technology transfer and training and supervision. However, the majority of informal firms are excluded from these linkages. Measures which governments may take to promote linkages include: first, the reservation of a significant percentage of public orders for those micro, small and medium enterprises (MSME) that comply with the regulations. This may encourage increased formalisation of MSMEs.<sup>26</sup> Second, to address the exploitative nature of formal-IS linkages and to enhance the institutional environment through which these linkages operate (Sethuramann, 1997). This can be done by increasing the number of suppliers and buyers linked to informal enterprises and excluding the middlemen who add no value to the transaction process. Sri Lanka for example, is considering establishing regional markets to enable farmers to sell directly to final buyers (Becker, 2004). Some regulations may be put in place to govern subcontracting arrangements so as to reduce the exploitation of informal enterprises by large enterprises. Third, the creation and enhancement of business associations which foster the interests of informal enterprises; such associations may increase the bargaining power of members during negotiations with other stakeholders, offer information, resolve conflicts among members, and facilitate the provision of security services.<sup>27</sup> They also offer BDS in advanced clusters.<sup>28</sup> Workers in informal enterprises also need to organise themselves within their unions while the governance structures of existing associations need to be enhanced too.

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<sup>26</sup> Eighty percent of micro enterprises in Ecuador are registered and comply with some labour regulations to have access to public orders (Morrisson, 1995).

<sup>27</sup> Sethuramann (1997) reports the success of the association of rickshaw operators (pullers) in India in managing to acquire the ownership of assets (vehicles) they utilised. The creation of the association was facilitated by a local NGO (Industrial Service Institute) but the success of the movement was sabotaged by other stakeholders and the Government's failure to coordinate relevant policies and regulations.

<sup>28</sup> Examples of BDS include the provision of technical services, training, and facilitating the marketing process.

## Practical Measures

The view that the IS is a temporary phenomenon which may disappear as the economy grows, (and therefore does not require government intervention since it may lead to market distortion), is refuted by the increase in the size of the IS despite economic growth. This has triggered initiatives by governments and other stakeholders related to the promotion and formalisation of the IS. The sections below address selected initiatives some of which (e.g. Shanghai Municipal Government, the National Productivity Institute [NPI] in South Africa, and Self-Employed Women's Association [SEWA]) are among those identified by ILO as the best international practices.<sup>29</sup> Radio Programming and Journalism is an emerging approach supported by the Swedish International Development Agency (Sida) that creates awareness and educates MSMEs through the media.<sup>30</sup>

### Government Initiatives

*China.* The reorganisation of public enterprises in China has resulted in massive redundancy among workers (see Howell 2002). The Shanghai Municipal Government has set up a programme to assist retrenched workers form individual labour organisations.<sup>31</sup> In cooperation with volunteer experts, it tries to enhance the growth and development of these organisations.

To speed up the registration process and assist informal enterprises, the Shanghai Municipal Government established special administrative organs known as Employment Service Organisations (ESO) at different levels: city, district, county and street committee. The Street Committee Employment Service Organ (SCESO) provides the seal of approval for the formation of a business, it registers employees, assists in setting up bank accounts, issues receipts, and organises data collection for the higher authorities. It also offers technical assistance, training, advice on relevant government legislation and for the formulation of business plans. It provides an arena for negotiations between informal contractors and their clients. Moreover, it acts as a guarantor for informal labour organisations applying for bank loans and as a representative of these organisations during the discussion with government institutions. Thus, SCESO is similar to a business association for informal enterprises.

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<sup>29</sup> De Medina, in: <http://decon.edu.uy/eventos/diez.ppt>.

<sup>30</sup> It is important to note that some of the initiatives addressed are based on the information from donors' policy papers which may not offer a clear understanding of what is being implemented on the ground. Furthermore, the information on how effective and successful these initiatives are is insufficient.

<sup>31</sup> Individual labour organisations are like informal enterprises that offer services, whose provision is dominated by labour input and insignificant investment in physical assets. They are not registered with the Industrial and Commercial Bureau though they are recognised by the Shanghai Municipal Government.

The Government also issued special protective measures to augment informal labour organisations and guarantee decent employment. These measures include preferential policies for their participation in basic social insurance schemes, free training for employers and employees in the IS, preferential tax policies (exemption from local taxes for a period of three years), risk insurance and credit supports. The informal labour organisations pay some amount of risk insurance of which 50 percent is covered by the Government. Established cooperative linkages between the Government and banks facilitate the provision of credit. The Government has also set up around 57 points in the city where informal labour organisations can apply for start-up loans with the City Employment Promotion Fund as guarantor. Among the conditions for receiving a loan is the assurance of the creation of new jobs. Despite these governmental initiatives however, a survey conducted on 500 informal organisations in Shanghai revealed that 25 percent reported that their formalisation was hindered due to the strictness of the governmental requirements; only 25 percent had converted into formal businesses.

*South Africa.* High unemployment and inequality forced the South African Government to reshape its private sector promotion strategies and to give special attention to MSMEs and the disadvantaged population.<sup>32</sup> In 1994 a national small business strategy was formulated to create an enabling environment for SMEs, to facilitate the equalisation of income, wealth and economic opportunities, to create long-term jobs, to strengthen networking among small enterprises, to level the playing fields between big and small business, and to support MSMEs' international competitiveness.<sup>33</sup>

The NPI is a unit under the Government's Department of Labour which aims to improve the productivity of MSMEs and to facilitate their linkages with the formal sector and markets.<sup>34</sup> In order to meet its objectives, the NPI offers productivity training and facilitates linkage creation using an insourcing model. Regarding the provision of productivity training the NPI has introduced its productivity concepts at different levels of the education system: vocational training centres, schools and universities. It links training institutions to MSMEs which has resulted in some university students carrying out their practical assignments in MSMEs and trying to solve the problems faced by MSMEs. It conducts workshops on productivity awareness, endeavours to reach specific markets and also offers productivity training to owners and employees. In 2002 it reached 240 MSMEs and poverty alleviation projects

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<sup>32</sup> In 1995 households in the top quintile had incomes more than 7.63 times the incomes of households in the lowest quintile but by 2000 the ratio had dropped to 5.78. In 2003, the 'broad' unemployment rate (i.e. people who want to work but have been discouraged) was 42.1 percent (Gelb, 2004).

<sup>33</sup> See [www.polity.org.za/html](http://www.polity.org.za/html).

<sup>34</sup> See [www.nedlac.org.za/links/gov.html](http://www.nedlac.org.za/links/gov.html), [www.npi.co.za/home.htm](http://www.npi.co.za/home.htm).

offering awards to the best practicing firms, encouraging MSMEs to increase their productivity.

As regards the creation of linkages through the in-sourcing model, the NPI has been involved in several projects (e.g. National Social Plans) with the aim of creating jobs and re-employing retrenched workers. It organises retrenched employees into business groups which tender for the supplying of services outsourced by their former employers.<sup>35</sup> In 2002 it assisted NEHAWU retrenched employees in organising themselves to run student restaurants and to get employment in enterprises that won tenders to supply cleaning and horticultural services. This initiative saved 140 jobs out of 217 and also helped 10 community based projects to assume their business status. The NPI is also involved in projects aimed at improving working conditions but there is lack of information on its success.

#### Donor agency and Private Initiatives

The initiatives of donor agencies in the IS are part of their private sector development strategies (PSD). Examples of specific donor agencies are:

*Sida.* The reviewed micro-enterprises' programs supported by Sida focus on the supplying of micro-financing, infrastructure development, the enhancement of market access, the creation of awareness of BDS for MSEs and providing education through the media.<sup>36</sup> The Program for Local Development (Sida/Natur) in Nicaragua allocates community grants for the provision of infrastructure, offers micro-credits to micro-enterprises and housing loans to poor families. Micro-credits to small businesses have enabled the working poor (particularly home-based women-owned businesses) to strengthen and develop their economic activities. It is reported that some have been able to expand the range and quality of products offered to their clients, others have increased sales and created employment. The housing loan program brought about an increase in the family ownership of title deeds from 15 percent in 1994 to over 70 percent in 2001. To enhance market access, FONDEAGO (Sida/Natur) facilitates the production and marketing of coffee and other commercial products produced by small farmers in two departments in Nicaragua. It also offers credit and training and assists in the registration of land.

Sida, in cooperation with ILO, has introduced a Radio Programming and Journalism initiative targeting MSEs in Uganda. The program offers marketing information (Hitchins et al., 2004) to create public awareness of BDS (Becker, 2004), holds technical discussions to edu-

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<sup>35</sup> Kirsten and Rorgerson (2002) describe this as the insourcing model of linkages which refers to the creation of in-house opportunities targeted at formally disadvantaged staff. They report that the Southern Sun group hotels, through its insourcing program initiated in 1994 have 29 insourcing groups.

<sup>36</sup> See Becker (2004) on detailed information regarding these programs.

cate MSEs and help them solve their problems, and gives interviews with successful business operators (Hitchins et al., 2004). The first radio program was launched in 1999 and by 2004 22 radio programs were broadcast in 12 local languages on 18 radio stations (i.e. 21 percent of the total radio stations) (FIT-SEMA, 2004). The radio program is considered successful since it reaches around two thirds of Uganda's poorest members aged 15 years and above and helps to resolve business conflicts (FIT-SEMA, 2004). However, the air time provided to address income generation, agriculture and health issues is not enough and issues under discussion were not sufficiently covered or followed up.

SEWA. SEWA is an association of poor, self-employed women and workers in the IS.<sup>37</sup> It was registered in 1972 and grew out of the Textile Labour Association becoming independent in 1981. As its members have no formal employers, it does not campaign against them. Its main objectives are to achieve greater employment, income, food and nutrition, housing/assets, and better health and child care for its members. It also tries to enhance organisational strength, leadership and self-reliance. The members of SEWA include hawkers and vendors (9 percent); home-based workers such as weavers and potters (34 percent); and manual labourers and service providers (57 percent).<sup>38</sup>

SEWA is said to be successful in accessing workers in the IS for in 2003 its total membership was seven hundred thousand.<sup>39</sup> Other organisations (in South Africa for example) face difficulties in accessing these workers since they fear loosing their jobs if they were to be recognised by their employers (Goldman, 2003). This is exacerbated by high unemployment and the threat of the quick substitution of a worker for a job seeker. SEWA handles this problem by creating more employment opportunities through organising un(der)employed workers into co-operatives, increasing their bargaining power and access to business opportunities.<sup>40</sup> Crowley et al. (2005) report on SEWA's success in formalising waste pickers by unionising and supporting them in marketing collected waste, and encouraging them to upgrade and diversify their skills. This may enable them to create co-operatives in other lines of business and to raise and sustain their employment. In 2000 it sponsored more than 80 co-operatives covering different areas of production and services (Bhowmik, 2005).

Steps undertaken by SEWA to provide banking services, housing funds, health care, child care, insurance, legal aid, capacity building and marketing of members' products through the internet, trade-fairs and different international contacts may result in the improvement of workers' conditions and the formalisation process (Sudarshan, 2002). A good number of

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<sup>37</sup> See [www.sewa.org/aboutus/index.htm](http://www.sewa.org/aboutus/index.htm).

<sup>38</sup> The latter group includes: agricultural labourers, construction workers, contract labourers, hand-cart pullers, head-loaders, and domestic workers.

<sup>39</sup> See SEWA, in: [www.sewa.org/annualreport/ind.htm](http://www.sewa.org/annualreport/ind.htm).

<sup>40</sup> See [www.sewa.org/aboutus/index.htm](http://www.sewa.org/aboutus/index.htm) → organisation → organisation in rural areas.

artisans have managed to exhibit their textile products in France. Co-operatives for health-services and child care provide services for the poor and formal employment for their members.

### **Assessment of Proposed Measures and Practical Examples**

The literature addresses measures that can be taken to lessen the misuse of public funds, to raise local-level accountability, and to encourage the participation of informal enterprises in societal organisations. However, it does not explicitly emphasise the need for the improvement in quality of the economic infrastructure and public services which also explain the degree of firms' formality.<sup>41</sup> In the majority of low income countries, the rural areas are still disconnected from urban areas which limit rural-urban economic integration, growth and formalisation. There are still no measures suggested for improving accountability, effectiveness and efficiency at the national-level.

Formalisation and poverty reduction are related to the use of formal labour which emphasises the need to address employment and working conditions in the IS. The literature addresses the issue of dual labour legislation, particularly minimum wage and social insurance but it is unclear how other issues should be dealt with. The Shanghai Municipal Government approach to providing social insurance services to informal workers (firms pay a certain percentage and the Government subsidises the rest) seems to be a good method. Organisations such as ILO have started to address these issues whilst acknowledging the lack of information available on how to deal with them (ILO, 2003). Some measures taken by global lead firms in cooperation with NGOs campaigning for fair trade aim at shaping the firms of the developing countries linked to them. They offer better prices to improve the working and employment conditions of firms in developing countries; donor agencies and governments may need to encourage this approach.

In China the uniqueness of the Shanghai Municipal Government's approach to business financial issues is its assistance in risk insurance, the provision of loan guarantee services, and the presence of cooperative relationships between the government and loan providers. However, the condition of creating new jobs may limit the access of firms to financial services, since the majority of them are unsure of their future success at such an early stage. An alternative condition which could be applied is the improvement in productivity which may enhance the growth of a firm and increase formalisation.

In South Africa, the NPI approach seems sustainable and long-term in nature as its productivity training is integrated in the education system. However, its success in relation to the

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<sup>41</sup> Yu (2002) also observes a general lack of studies addressing the question of infrastructure.



formalisation of MSMEs is based on an insignificant percentage of participants and therefore makes it difficult to draw conclusions.

Sida programs apparently increase the formality of MSEs through the formalisation of property (land and house) ownership. Their accessibility to productive resources such as loans may increase as their (owned) property can be used as collateral. The provision of housing loans and the discussion of health issues on small radio programs focus on the living conditions of the poor and therefore may reduce poverty. The programs try to resolve conflicts between local governments and MSEs, facilitate contract enforcement and enhance market access to MSEs. They also create awareness of various technical issues relating to MSE operations. However, the programs have not yet covered policy issues (e.g. legal, tax) or strengthened MSEs' and informal workers' associations. The evaluation of the programs is based on a qualitative analysis and it is not possible to delineate the extent to which they have impacted on the growth of MSEs and facilitated linkage between BDS providers and MSEs.

The SEWA movement has gained national and international popularity with organisations in Yemen, Turkey and South Africa trying to copy it. Its political achievements include the set-up of a national commission of labour which evaluates the current labour legislation and proposes amendments to cover informal workers. Its founder Elaben Bhatt is a member of this commission. Thus, SEWA seems to influence government policies by lobbying for policies favourable to its members.

While some case studies and SEWA's 2003 annual report<sup>42</sup> confirm its success based on increasing membership, a quantitative and representative empirical study analysing the relationship between its membership and the livelihoods of the poor workers is lacking. The sustainability of its activities is also questionable given the limited contributions from its members. In 2003 it received less than 3 percent of the funds from its own members, 76 percent came from donors, 8 percent from Central and 6 percent from the State (Crowley et al., 2005). Although membership-based organisations for the poor can provide a point of entry for donors who want to support bottom-up initiatives aimed at formalising informal enterprises and workers, a high dependence on donor funds may weaken the ownership and accountability of the organisations to their members.

Researchers from the Rural Institutions and Participation Service of the FAO highlight the probable consequences of the dependence of MBOP's (membership-based organisation of the poor) on donor funding and their views support the above arguments (Crowley et al., 2005). They categorise MBOP into those initiated by the poor and those established by donors. The former represent a more reliable basis for strong and lasting solidarity but are

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<sup>42</sup> See SEWA, in: [www.sewa.org/annualreport/ind.htm](http://www.sewa.org/annualreport/ind.htm).

sometimes limited in scale and in the diversity of their activities. The latter are often easier for outside organisations to work with, better documented, and have more resources but are often less stable and run the risk of losing their pro-poor focus, autonomy and effectiveness. The presence of the latter in a society may weaken the development of the former, which are more genuine. Those organisations founded primarily to tap outside resources are unsustainable. The success of MBOP is said to depend on the participation of the poor people themselves by collectively defining the objectives and maintaining an equity stake in the organisation (i.e. making a significant contribution).

## **6. Conclusion and Recommendation**

The quest to formalisation enterprises needs to be addressed from various different angles, viz., reducing entry and operating formal costs, increasing the incentives for MSEs to operate formally, reducing obstacles to their growth, and searching for inexpensive approaches through which to enforce compliancy with government regulations. This can be achieved by undertaking the following measures.

The reduction of entry costs can be accomplished by having a one stop-shop for registration, decreasing registration procedures, and increasing the effectiveness and efficiency of offices involved in the registration process. Following the approach of the Shanghai Municipal Government, the one-stop-shop can be organised at different levels namely local, municipal/district, regional and national. At local level the one-stop-shop may need to facilitate the registration process by providing enterprises with all the information, helping them to meet all the registration requirements; while the hostile behaviour of government officials towards informal enterprises should be outlawed.

The national tax system needs to be well structured, clear and transparent. Local levies may be transformed into fees for the use of community resources in order to encourage the efficient provision of local public services and accountability. Measures aimed at enhancing national-level accountability need to be taken.

Straightforward property right registration and efficient contract enforcement mechanisms which recognise and incorporate informal, popular rules need to be brought into the process of securing property rights. Ways to link multilateral private governance structures and the formal judicial system in relation to contract enforcement may have to be found to simplify the process, increase its effectiveness and efficiency and improve its reach to all business operators. The small radio programs in Uganda demonstrate that disputes between the Council and MSEs can be resolved.

Dual labour regulations and safety nets are necessary to enable informal enterprises to meet part of their labour contributions while staying in business and offering employment. The introduction of dual safety nets for this purpose (whereby informal enterprises pay a certain percentage and the rest is covered by governments through their poverty reduction strategies) would be necessary. Informal enterprises may need to be sensitised to the need of improving employment and working conditions. This needs to be incorporated into training programs that target Informal enterprises. NGOs, local public governance structures, informal labour associations in cooperation with local and global lead firms need to encourage fair trade labelling.

Following the South African approach, training concepts for informal enterprises need to be introduced in vocational training programs. Students following these programs can be assigned to informal enterprises in order to conduct their practical tasks which would enable them to learn more as future entrepreneurs and facilitate the solving of problems faced by informal enterprises. The diversification of products offered by financial institutions may need to incorporate security insurance and the establishment of limited liability institutions to encourage high return-high risk investment. The provision of BDS and financial services needs to be very realistic and objectively evaluated.

Training programs designed for MSMEs may need to incorporate modules focusing on improving worker capabilities. Employers should be encouraged to allow their employees to attend training courses which in turn may also increase their employment potential.

It is important to encourage the creation of informal-formal sector forward linkages. Measures to overcome exploitation need to be considered. Actors who add no value in the chain linking informal and formal firms need to be removed which can be done by facilitating the creation of direct links between value adding informal and formal enterprises.

The formalisation of informal enterprises can be viewed as an empowerment process and a poverty reduction strategy when considering capabilities poverty for it entails legal/official recognition of the living conditions of the poor and their sources of income. This can be possible if the voices of employers and employees in the IS are empowered. If the actors of the IS participate in decision making and the formulation of policies/regulations they may in turn be motivated to comply with them. Increased formalisation requires incentives that is to say; the provision of public and infrastructural services needs to be obvious, efficient, reliable and cheaper.

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