Entry Regulation and Formalization of Microenterprises in Developing Countries

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Abstract

The majority of microenterprises in most developing countries remain informal despite more than a decade of reforms aimed at making it easier and cheaper for them to formalize. This paper summarizes the evidence on the effects of entry reforms and related policy actions to promote firm formalization. Most of these policies result only in a modest increase in the number of formal firms, if at all. Less is known about the impact of other forms of business regulations on the performance of low-scale enterprises. Most informal firms appear not to benefit on net from formalizing, so ease of formalization alone will not lead to most of them formalizing. Increased enforcement of rules can increase formality. Although there is a fiscal benefit of doing this with larger informal firms, it is unclear whether there is a public rationale for trying to formalize subsistence enterprises.

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Making it easier to formally register a business is the area of business regulatory policy that has seen most attention from policymakers over the past decade, with the Doing Business project of the World Bank finding 368 reforms took place in 149 economies between 2003 and 2012. As a result of these reforms, the world average time to start a business has fallen from 50 days to 30, while the cost of starting a business is one-third of what it was (World Bank, 2013).

However, despite these reforms, the majority of businesses in most developing countries remain informal. By formality, we mean whether a business is registered for the relevant municipal licenses and with the tax department. For example, Brazil simplified its taxation system for small businesses and the state of Minas Gerais introduced a “one-stop shop”, which is a popular way of streamlining the registration process for firms worldwide. After these efforts, a government survey found 72 percent of enterprises in the state were still informal (Andrade et al, 2013).

Informality rates are highest for low-scale enterprises: de Mel et al. (2013) report that only 39 percent of Sri Lankan businesses with one worker are registered for taxes, compared to 68 percent of those with five workers and 78 percent of those with 10 workers. Most small firms in developing countries have only one or two workers. For example, in Mauritius, out of the 91,980 units with 9 or fewer workers, 70.6 percent have only one or two workers, and only 6.2 percent have five to nine workers (McKenzie, 2011). By virtue of the sheer quantity of one and two person firms, and their much greater prevalence to be informal, most of the stock of informal firms in developing countries will consist of low scale enterprises consisting of the owner and at most one other paid worker.

The key question for policymakers is then what, if anything, should they attempt to do about this vast quantity of small-scale informal firms? One view, popularized by Hernando de Soto (1989), is that these informal firm owners would like to be formal, but costly regulations and bureaucracy prevent them from doing so, causing a productivity loss for these firms. The implication is that policymakers should attempt to reduce these barriers and bring these firms into the formal sector. A competing view, associated with Maloney (2004) and others, is that firms which would benefit from formalizing do so, while smaller and less productive firms rationally opt out of the formal sector since they perceive little benefits from becoming formal. A related view is the segmented labor market perspective, in which the informal sector is seen as “the free entry sector of last resort” catering for individuals who would rather be in paid employment but are unable to find formal wage jobs (Fields, 2004, p.17). An implication is then that it is not privately optimal for these firms to formalize, so policymakers should only try and bring them into the formal sector if there is a compelling public rationale for doing so.
In practice the large number of informal firms with at most a couple of workers are likely to cover a mix of different types of firms, including subsistence enterprises and individuals who would rather be wage workers, but also potential entrepreneurs with the desire and sometimes ability to grow their businesses over time. De Mel et al. (2010) classify the self-employed in Sri Lanka using statistical methods designed for species classification in biology, and find that between one-quarter and one-third of the self-employed appear to share characteristics that give them the potential to be owners of somewhat larger firms, while the remaining two-thirds to three-quarters look much more like wage workers. Our focus is on the role of business regulations on the formalization decisions of this overall group of small scale enterprises, before discussing the extent to which policy can differentiate among them. We note also that while our focus is on regulatory policy, governments have a number of other policy tools such as credit and labor market policies that will also affect the decision of individuals to operate firms at all, and if so, whether to do so formally or informally.

DISCUSSION OF KEY FINDINGS

We divide our discussion of key findings into two subsections. The first considers the extent to which business regulations appear to be barriers to firms becoming formal, and whether efforts to make it easier for firms to formalize or tougher to remain informal have succeeded in bringing low-scale enterprises into the formal sector. The second subsection then examines the extent to which being formal benefits these types of firms. Attempts to answer both sets of questions must deal with the fact that places that change regulations may differ systematically from those which do not, and that firms which choose to become formal are likely to differ in many unobservable ways from those who choose to remain informal.

*Measuring the impacts of formalization efforts and of becoming formal*

Simple comparisons of formal and informal firms usually reveal that formal firms are more productive and profitable. A series of high-profile sector studies by the McKinsey Global Institute comparing the operation of formal and informal firms in a number of countries around the world concluded that informality has a very negative impact on productivity, accounting for nearly 50 percent of the overall productivity gap between countries like Portugal and Turkey and the United States (Farrell, 2004). La Porta and Shleifer (2008) use World Bank firm surveys to compare the productivity of informal and formal firms, and find the formal firms to have substantially higher productivity levels.
However, such estimates assume that firms do not choose whether or not to be formal. In practice though, firms are likely to weigh up the potential benefits of being formal (greater access to credit, more scope for marketing, participation in government contracts and programs, reputation effects, less risk of fines) with the costs of becoming formal (the time and money costs of registering) and of being formal (ongoing taxes, accounting costs, paperwork). As a result, individuals who see large benefits to becoming formal will do so, while less productive and smaller firms who see little benefits of formalizing will likely choose to remain informal. As a result, lower productivity is likely to be just as much a cause as a consequence of informality, and simple comparisons of formal and informal firms will greatly overstate the productivity benefits of formalizing.

In order to account for the likelihood that firms which choose to become formal are different from those who stay informal, one would ideally randomly choose some firms and make them formal, and leave other similar firms informal, and then compare the two. This approach is known as the randomized experimental approach, and has been used in a number of attempts to formalize firms through providing them with information and lower costs of registering (Jaramillo, 2009; Alcázar et al., 2010; de Mel et al., 2013; De Giorgi and Rahman, 2013; Andrade et al., 2013).

When randomization has not been possible, a number of studies have used a variety of non-experimental econometric methods designed to ensure they can measure the causal effect of policy efforts to spur formality, or of the consequences of formalizing. For example, McKenzie and Sakho (2010) use an instrumental variables method to measure the consequences of being formal in Bolivia, arguing that firms which are closer to the municipal tax office have more information and lower costs of registering than otherwise similar firms located elsewhere in the same city. Bruhn (2011) uses a difference-in-differences method, comparing changes in formalization rates of firms in municipalities in which entry regulation was simplified earlier to those in similar municipalities in which the reform came later. These non-experimental methods require more assumptions to establish causality than are needed with randomized experiments, but also represent serious attempts to deal with the self-selection of firms into formal or informal status.

The following section discusses findings from both randomized and non-experimental studies on the causal effect of policies to promote firm formalization (see table 1 for a summary of the key results from these studies).
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The effect of business entry reforms on number of firm registrations

A number of studies have examined the impact of business entry reforms on firm registration in different Latin American countries, exploiting cross-time and cross-municipality variation in the implementation of these reforms. A common element in these reforms is that they opened one-stop shop service points and thus eliminated the need to visit several different government offices for completing the registration process, lowering the time and/or cost needed to register a business. These studies find that a large reduction in the cost and time taken to register a firm leads to a modest increase in the number of formal firms.

A reform in Mexico, which was implemented in some of the most populous and economically developed municipalities starting in 2002, reduced the number of days taken to start a business from 30.1 to 1.4. Bruhn (2011) uses data on individuals’ employment status from the Mexican Labor Market Survey (ENE) to show that this reform increased the number of registered business owners by 5 percent. Kaplan, Piedra, and Seira (2011) find that the same reform increased the number of new firm registrations with the Mexican Social Security Institute (IMSS) by 5 percent, using administrative data.

The Colombian government implemented a one-stop shop that reduced the time required to register a business from 55 to less than 9 days and lowered registration fees by 30 percent. Cárdenas and Rozo (2009) use administrative data from Chambers from Commerce in six major cities to show that the reform led to a 5 percent increase in businesses registrations.

Entry reforms appear to have less of an effect on business registrations in less populous and more remote areas. Bruhn and McKenzie (2013) analyze the impact of the Minas Fácil Expresso program in the state of Minas Gerais, Brazil. This program aimed to extend the benefits of a one-stop shop to less populous municipalities, thereby removing the need for firms to register separately at their municipality and then travel to register with the state and federal governments in a larger town or city. They find this program actually led to a reduction in the number of firms registering during the first two months of implementation (perhaps due to officials learning to use the new system), with no subsequent increase.

The majority of these studies cannot disentangle whether the increase in registrations is due to informal firms registering or new firms being created by individuals who did not run a business before. The labor
market survey used by Bruhn (2011) is an exception, and she finds that the increase in registered businesses was due to wage earners opening new businesses.

**Does making it easier to register a firm cause formalization of existing informal firms?**

A follow-up study by Bruhn (2013) examines the impact of the business registration reform in Mexico on informal business owners in more detail. This paper takes into account that informal business owners are heterogeneous and some may be looking for a wage job instead of aiming to continue or grow their business. Bruhn splits up the group of informal business owners into those who have personal characteristics like formal business owners and those who have characteristics like wage earners and examines the impact of the reform separately for these groups. The results show that wage earner types are less likely to register their business due to the reform, but more likely to become wage workers since the reform created jobs. On the other hand, informal business owners with characteristics like formal business owner are more likely to register, but only in municipalities with high pre-reform constraints to formal entrepreneurship. The effects are relatively small though and most informal business owners remain informal even after the reform.

Some countries experience a large spike in firm registrations after the introduction of a business registration reform. For example, Mullainathan and Schnabl (2010) document that the number of firm registrations increased from 1,758 in the year before a municipal licensing reform in Lima, Peru, to 8,517 in the year after a reform. They conduct a survey to show that about 75 percent of the firms that registered in the year after the reform were previously informal and 25 percent were new firms. However, the majority of newly issued licenses were provisional, meaning that they had to be renewed every year. Many firms do not seem to have renewed the license after the year was over since the number of registrations dropped again to 3,500 in the second year after the reform, suggesting that the increase in formalization was temporary.

**The effect of providing information about how to register, or lowering the cost of formalizing, on formalization rates**

Surveys of microenterprises typically show that many informal firms are not very well informed about either the process of formalizing, or the costs involved. They often overestimate the time and cost involved, particularly following efforts to simplify the registration process. For example, in Sri Lanka de Mel et al. (2013) report that only 17 percent of informal firm owners know the cost of registering. Most thought the process of registering would take over a month compared to one week or less in practice,
and only 2 percent knew that lower incomes were not liable for business income taxes. In Bolivia, McKenzie and Sakho (2010) report that only one-third of informal owners know where the tax office is located (which is the registration location), and only 10 percent have even heard of the commerce registry.

A natural policy response to this lack of information is to try and provide information to firms about how to register, and about the possible benefits of formalizing. However, two randomized experiments which have done this have found zero resulting increase in formalization. In Belo Horizonte, Brazil, Andrade et al. (2013) gave a glossy brochure prepared by a marketing team of the State Government to 208 informal firms, and find that firms receiving this brochure were no more likely to register over the following year. In Bangladesh, de Giorgi and Rahman (2013) had field staff deliver information and brochures to 1500 informal firms, and find that fewer than 5 percent registered, with this number being no greater than control group firms not given the information.

Two randomized experiments also investigate the impact of lowering the cost of formalizing along with this information. In Sri Lanka, de Mel et al. (2013) provide information and agree to reimburse the full cost of registering for taxes (approximately US$10) to 104 firms, with only one firm taking up the offer and formalizing. In Belo Horizonte, Brazil, Andrade et al. (2013) provide information, have the government waive all registration costs and the sanitary and inspection taxes for the first year (approximately US$200), and provide free mandatory accounting services for the first year (approximately US$1800). This package of information and reduced costs is offered to 255 informal firms, with again only one single firm taking up the offer. Lowering the cost of registering for taxes thus appears to have very little impact on registration of existing firms. One reason for this finding may be that the ongoing costs of being registered, including tax payments, accountant costs, and other fees, still deter firms from registering even if the process of doing so is simplified.

In many countries, the formalization process requires registration with more than one government agency, implying different ongoing costs of being registered with each agency. A municipal license is often the first license that informal firms receive, and because it typically then requires only a small annual license fee, but no sizeable local tax payments, it is less expensive for firms than registering with the national (and state) governments for business taxes. We therefore might expect to see firms being more willing to obtain this license if its cost is lowered. Evidence along these lines comes from a randomized experiment conducted by Alcázar et al. (2010) in Lima, Peru. They follow-up on a reform which had lowered the time to get a municipal license from 160 days to 1.6 days by trying to induce
firms to obtain a municipal license through offering a subsidy of between 27 and 35 percent of the cost of the license (or about US$30) to 300 informal firms. They find that the subsidized cost offer led to approximately 10 to 12 percent of informal firms obtaining a municipal license.

**Does increased enforcement cause more firms to formalize?**

While policy and research attention has focused on trying to simplify the regulations facing firms, much less attention has been given to the effects of better enforcement of the regulations which are in place. A sizeable minority of informal firms report having received some form of inspection visit over the past year (most often from the municipality), but very few report having been fined in the countries where we have collected data. For example, in Sri Lanka, 43 percent of informal firms were visited by a municipal official, but only 0.8 percent paid any fines (or bribes); in Brazil, 33 percent of firms were visited by a municipal official, but only 2.1 percent had paid any fine; and in Bolivia, fewer than 2 percent of informal firms report having been fined.

The randomized experiment of Andrade et al. (2013) shows that more enforcement by inspectors can induce some informal firms to become formal. They randomly allocated 577 firms to receive inspection visits from municipal inspectors. Their results point both to the difficulties in inspecting informal firms – the inspectors were unable to locate some of these firms or talk to their owners – as well as to the potential impact on formalization – the authors estimate that between 22 and 27 percent of firms that received an inspection as a result of their intervention registered with the municipality.

A complementary approach is to put in place incentives for customers to demand firms be formal. One way to do this is a lottery tax receipt system, whereby each tax receipt is printed with a lottery number, with a drawing for monetary prizes giving customers an incentive to ask for receipts. Such a system has been used in Taiwan, China; Korea; China; and Puerto Rico. Wan (2010) compares changes in tax revenues in districts in China which introduced this reform to those which didn’t, and finds the introduction of this tax receipt lottery increased sales tax revenue by 17 percent.

**Despite formalization policies, the majority of low scale firms in developing countries remain informal**

As noted in the motivation section, the majority of self-employed individuals and firms with only one or two workers remain informal in many developing countries, despite the decade of reforms intended to simplify business registrations. All of the studies described above which have provided information and lowered the cost of formalizing have found at most a small fraction of informal firms choose to formalize
when given this help to do so. This finding contrasts with the view of de Soto (1989), and suggests firms are deciding that the benefits of formalizing do not exceed the costs in many cases. An experiment in Sri Lanka provides the strongest evidence for this view, showing how more firms become formal as the benefits of doing so increase.

De Mel et al. (2013) offer informal firms different amounts of money to become formal, ranging from just enough to cover the cost of tax registration, up to 40,000 Sri Lankan Rupees (US$350). The largest amount is equivalent to approximately two months’ profits for the median firm. They find that while no additional firms register when just the cost of registering is covered, 20 percent of firms register when offered 10,000 Sri Lankan Rupees, and 47 percent when offered the maximum amount of 40,000. Combining these incentives to register with the initial registration costs and the discounted value of future tax payments facing these firms, they are able to examine how the demand for formalizing varies with the net cost of registration. We see a steep downward demand curve (Figure 1), with the proportion of firms willing to become formal dropping quickly as the cost of formality increases. We would expect firms to formalize if they view the net benefits as exceeding these costs, so another way of reading this figure is to note that fewer than 15 percent of informal firms seem to view the net benefits of being formal as being greater than zero.

De Mel et al. note that many of the firms who did not formalize when offered the maximum amount cited other barriers, such as land titling issues as a constraint (the costs of overcoming these other barriers are not included in the net cost) while others said they did not find the benefits would outweigh the costs even with this monetary incentive. We look next at what benefits being formal offers firms.
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Informal firms are often referred to as “operating in the shadows”, afraid to market themselves widely or locate in very visible locations for fear of attracting the attention of the law. In addition, firms which do not issue tax receipts may not be able to sell to certain customers, such as the government or larger firms. As a result, one of the channels through which formalizing may help firms is through expanding their customer base.

This is the channel which has most support from different studies in the literature. In Bolivia, McKenzie and Sakho (2010) find that firms that become formal as a result of being located slightly closer to the tax office issue more tax receipts and have greater sales. In Brazil, Fajnzylber et al. (2011) find that firms that open up just after introduction of the SIMPLES program, which simplified regulation by combining different types of tax registrations and payments, are more likely to operate in a permanent location, although this could reflect a change in the types of individuals which decide to open firms after the reform, instead of a causal impact of formalizing. In Sri Lanka, firms which formalized as a result of experimental inducement are 26 percentage points more likely to advertise (de Mel et al, 2013).
Two other main channels through which formalization is often hypothesized to benefit firms are improved relationships with the financial sector and increased access to government benefits. Existing studies find no evidence of these effects. In Sri Lanka, de Mel et al. (2013) find firms which formalize are not any more likely to get a business bank account, business loan, make sales to the government, or participate in a government program. In Bolivia, McKenzie and Sakho (2010) find no impact on the likelihood of a bank loan or of sales to the government. A likely explanation is that many informal firms would not receive credit even if they did register, while those for whom registration is the only barrier preventing them from getting credit would have already chosen to become formal. The same is likely to apply to government contracting, with most small scale firms not likely to sell to the government, and those that do formalizing when this need arises.

Consistent with the viewpoint that most firms are rationally choosing whether to formalize or not on the basis of comparing the expected benefits of becoming formal to the costs of doing so, studies have found that the informal firms who have been induced to become formal by subsidized costs have experienced little benefit on average from doing so. Alcázar et al. (2010) find no significant impact of obtaining a municipal license in Lima on firm profits or revenues. McKenzie and Sakho (2010) find that firms who would formalize if they were slightly closer to the tax registration office would appear to increase profits by doing so, but that the average informal firm would not. De Mel et al. (2013) do find a significant increase in average profitability, but show that this average increase is being driven by a handful of firms growing substantially after formalization, while most firms show no improvement.

Limitations and Gaps

The past five years have seen a number of innovative experimental studies measuring the impacts of policy efforts to increase formality, along with several relatively rigorous non-experimental studies. However, a number of limitations and gaps remain:

- The existing research comes from only a few countries, concentrated in Latin America and Southeast Asia, making it unclear the extent to which the findings would generalize to regions like Africa, the Middle East, and Eastern Europe where little evidence is currently available.
- Existing research has largely focused on the registration and tax regulations facing small-scale enterprises, with little work on the importance of other regulatory barriers for firm growth. Both the de Mel et al. (2013) and Alcázar et al. (2010) experimental studies note that land zoning and
titling regulations were key barriers which appeared to prevent firms formalizing, and more work on the impacts of policy efforts to improve these types of regulations is needed.

- There is a need for better measurement of both the regulations facing small-scale enterprises, and of their interactions with these regulations. For example, the Doing Business project has attempted to measure key regulatory burdens facing businesses around the world, but focuses on limited liability companies and not small-scale enterprises. The ease of starting a business measure considers a company with start-up capital of 10 times per capita income, turnover of at least 100 times per capita income, and between 10 and 50 employees (World Bank, 2013), and may not reflect the regulations facing small businesses. Few countries have data on the characteristics of firms registering and whether they are new or existing firms.

- Existing research has largely focused on the private costs and benefits of formalizing for informal firms. Two key public policy rationales for formalization require more research. The first is the claim that informality leads to inefficient resource allocation, since informal firms who do not pay taxes can compete away customers from more efficient tax-paying formal firms. The second is the view that formalization is socially optimal since it increases government revenues and a culture of respect for the rule of law.

Summary and Policy Advice

Efforts to dramatically lower the cost of registration and simplify the registration process have still left most small scale enterprises operating informally in many developing countries. While these firms would gain some benefits from formalizing in terms of being able to advertise more and issue tax receipts, they typically view these benefits as less than the costs of becoming formal and the ongoing taxes they must pay for being formal. Existing evidence suggests most of these firms are making what is a privately optimal decision, and so the policy rationale for trying to bring small scale informal firms into the formal sector should not rely on the belief that doing so will bring benefits to these firms. This does not mean that there is no cost to inefficient and costly regulations – making firm owners spend extra time and hassle in registering their firms is usually a pure social cost, and so efforts to simplify regulations will benefit those who choose to go through this process.

A key issue for policymakers is then whether there is a public rationale for attempting to formalize small-scale firms. There are several compelling reasons to try and bring larger and more profitable informal firms into the formal system. First, the need of most developing countries to widen the tax
base is likely to include a public rationale for collecting taxes from relatively well-off owners of informal firms, and for the revenue collected from them to justify the costs of formalizing them. Indeed, Andrade et al. (2013) suggest that inspecting informal firms earning an average of $1000 a month in profits in Brazil would formalize more than enough firms to pay for the costs of such enforcement. Secondly, these larger and more successful informal firms are more likely to be the ones competing with formal firms for customers, and so ensuring that such firms also become formal may cut back on unfair competition that prevents more efficient formal firms from growing faster. The challenge is then how to encourage formalization of such firms. Based on the evidence reviewed here, lowering the cost and complexity of registration seems a necessary, but not sufficient, step. Policymakers also need to increase enforcement of the simplified rules, and perhaps experiment with innovative approaches to encourage suppliers or customers to demand formality. One such example being tried in several countries is to link each tax receipt number to a lottery, so that customers have an incentive to demand a tax receipt on each transaction.

What about subsistence enterprises? Existing evidence seems to suggest that such firms see no benefits from formalizing, and would typically contribute very little to taxes if they did formalize. They may still compete with larger firms, but in the absence of other job opportunities for these individuals, the government may prefer to leave them alone rather than have them close down. The only remaining public rationale for trying to bring them into the formal sector is that the presence of so many informal firms may send a message to the public that obeying the law is optional, and also dissuade more prosperous informal firms from formalizing. This “broken-windows” theory of crime has some evidence to support it in developed countries (Keizer et al, 2008), but we are unaware of any such studies or efforts applied to informality in developing countries. An alternative approach used in some countries is to write the law in a way which does not require such firms with income below some threshold to register, making them in compliance with the law. But unless such a threshold is set very high, there are still likely to be many firms above the threshold who choose not to register.

Finally, given the limited existing evidence base and examples of policies not having their intended effects, policymakers attempting to innovate in this area would be well-served to build in rigorous impact evaluations, in order to measure whether any new efforts are achieving their desired goals. In addition to regulatory policy changes, this should include evaluating the effects of other government policy choices which seek to change the relative costs and benefits of being formal, such as credit and labor market policies.
Reference List


