Encouraging micro and small enterprises to formalize

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Existing interventions to encourage firms to formalize have been costly, and low take up has made it challenging to identify the benefits of formalization to firms. Policymakers may want to consider the broader benefits to society when deciding whether to invest in such policies.

A street with fruit stands and sellers.

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Summary

Informal firms are defined as those that operate outside of the legal and regulatory system and are therefore not registered for the required business operating licenses. Most businesses in low- and middle-income countries (LMICs) operate informally, representing more than 70 percent[1] of employment in LMICs and 30–40 percent of economic activity in the countries with the lowest income. We define formalization as the process of registering with all relevant authorities. Formalization in many countries entails registering with tax authorities, though in some countries these processes are separate, with eligibility for taxation based on firm size or other criteria.

According to observational studies, informal firms tend to be smaller and predominantly own account enterprises. Informal firms have only four employees on average, and are less productive than formal firms.[2], Operating formally may allow firms to grow by expanding their customer base, paying fewer fines, and gaining access to more government contracts, financial services, and business loans.[3] Access to these benefits may also be critical to surviving economic shocks, as underscored by the COVID-19

pandemic. However, registration costs time and money and is often associated with increased tax burdens, filing costs, and compliance with labor regulations. Firms weigh these costs and benefits in their decision to become formal.

A review of seven randomized evaluations and four quasi-experimental studies[4] found that most programs aimed at providing information or reducing the direct costs of registration failed to increase formal registration and that formalization itself had a limited effect on business performance. Enforcing existing regulations more and providing extra incentives for firms to formalize had the greatest positive impact on formalization.

One leading explanation for these results is that informal firm owners may be rationally choosing to remain informal, either because they want to avoid the costs of registration and any resulting tax responsibilities or labor regulations or because they prefer wage employment and are using these small firms as unemployment insurance. In other words, the benefits of formalization may be too limited to offset the costs to the firm. However, policymakers may still choose to promote formalization because of the social benefits beyond those that individual firm owners expect to gain, such as protecting workers through compliance with labor regulations, increasing tax revenue required for the provision of public goods, disbursing emergency relief in a timely manner to firms in times of recession or crisis, or fostering an environment where laws are adhered to. Alternatively, there may be societal benefits from formalization creating a level playing field for firms and thus preventing the misallocation of resources to informal firms.

Supporting evidence

Providing information to firms about the benefits of and process for registration did not increase the rate of formalization among firms, suggesting that there may be other constraints to formal registration. Four studies in Bangladesh, Benin, Brazil, and Sri Lanka provided information to firms about the benefits of formalization and the procedures for doing so [1], [2], [3], [5], . In all four cases, information alone did not have an impact on the rate of formal registration. In Bangladesh, for example, an information campaign increased reported knowledge about registration procedures, but did not change the likelihood of firms registering [1].

Removing the upfront costs associated with registration did not increase formalization. In two studies in Sri Lanka and Brazil, reimbursing firms the upfront costs of business registration in addition to providing information had no effect on formal registration [2], [3], . In Colombia, free registration complemented with in-person informational meetings with agents from the local chamber of commerce raised the likelihood that a business would begin to operate formally by 5.5 percentage points among firms that were invited to participate [6]. However, the effect disappeared one year later, suggesting that while some firms were willing to experiment with formality, many did not find it advantageous enough to continue operating in the formal sector.

Three quasi-experimental studies found that easing business entry procedures by reducing the time and complexity of registration was associated with mixed effects on formal registration, reducing or having no impact on formalization in Brazil, and increasing registration by new firm owners in Mexico [9], [10], [8].

Additional benefits including cash grants or other perks such as support for opening a bank account did tend to increase formalization, suggesting that firms may need additional incentives. In three studies, firms were more likely to formalize when offered extra incentives or services. For example, in Sri Lanka, providing firms with a cash grant equal to 0.5–2 months of their median profit led more firms to register, though the increase in tax revenue from registration was not projected to compensate for the cost of providing these benefits [2], . In Malawi, topping up business registration assistance with information on and access to a business bank account led to a 12 percentage point increase in the likelihood of formalizing [4], . Similarly in Benin, providing firms with supplementary services such as business training and support opening a bank account led to an

increase in formal registration, with the impacts larger as more supplementary services were offered [5]. This suggests that including supplementary services in Malawi and Benin could be the reason more firms formalized.

The tax responsibilities that come with formality may represent a key constraint to formalization. In Malawi, firms showed higher demand for business registration when it was separated from tax obligations [4], . In Brazil, a quasi-experimental study found that a program that eliminated registration costs, simplified the process, and substantially reduced the tax burden while opening access to social benefit programs was associated with a 76 percent increase in registration [11]. An interesting area for future research is whether partial formalization—business registration that is separate from tax obligation—allows small firms to enjoy the benefits of formalization while still generating tax revenue from targeting larger firms that may be less constrained in terms of credit and other inputs.

In two studies, stricter enforcement of existing regulations increased the number of formal firms. In Brazil, inspectors visited firms and warned them that they would be fined and shut down if they failed to formally register before the next visit (in 30 to 45 days). Firms that received inspection visits were 2 to 4 percentage points more likely to register (from a baseline of 5.6 to 7.5 percent in the comparison group, a 44 to 52 percent increase), and this increase was largely driven by firms that were already partially formal [3], . In Bangladesh, where tax representatives randomly visited firms and informed them of the punishment for failing to register with the Bangladesh National Tax Authority, only higher-revenue firms responded to the notice and registered [7]. Future research should evaluate additional methods of enforcement beyond inspector visits, as well as target high-revenue and partially formal firms with inspection, to identify which types of interventions have the greatest effect and which are most cost-effective.

Formalization had mixed impacts on business performance, suggesting that formal status may not be a primary growth constraint for some firms. Operating formally may allow firms to grow through an expanded customer base, see a reduction in fine payments, and gain greater access to financial services and business loans. While evidence on the impact of formalization on business performance is limited, two randomized evaluations found that formalizing did not improve profits or likelihood of survival for most firms. In Sri Lanka, firms that formalized were not more likely to obtain a business bank account or business loan, make sales to the government, or participate in a government program—outcomes that can contribute to higher profits [2], . However, a handful of firms grew quickly after formalizing and reported higher profits. In Benin, firms that formalized were more likely to participate in business trainings and performed more formal accounting, but similarly were not more likely to obtain business bank accounts or loans, did not gain more customers, and did not see an increase in profits. Neither evaluation found an impact of formalizing on job creation [5].

In contrast, in Malawi, firms that were offered business registration assistance in combination with a business bank account and information on how to use it experienced 20 percent higher profits and 15 percent higher sales [4], . Meanwhile, firms that only received business registration assistance alone or business and tax registration assistance did not see higher profits and sales. This suggests that formalizing can confer benefits, but in the Sri Lanka and Benin examples, may not have been what firms needed to jump-start their growth. Considering the limited effect of formalizing on performance alongside the overall low impact of formalization interventions on business registration, this suggests that many firm owners may be rationally choosing to remain informal. Future research should investigate for which types of firms formalization is most beneficial, and whether additional policies are needed for firms to obtain meaningful benefits [4].

In two studies that looked at gender-differentiated effects, women-led businesses were less likely to formalize than male-owned businesses [4], [5], . In Benin, researchers suggest that formalization was less appealing in the women-dominated markets in which informal female shopkeepers operated, because businesses already had to register with the entity in charge of the markets that provided some of the benefits of formalization [5], . In Malawi, this was likely because women were more likely than men to need their spouses' permission to register, and female-owned firms were more likely to have closed over the course of the study [4], . Future research should investigate how gender norms affect female microentrepreneurs' ambitions and whether this leads to lower demand to formalize for female microentrepreneurs [5].

Firms appear to be rationally informal and the direct benefits from formalization seem modest. Thus, policymakers may want to consider some broader benefits to society when deciding whether to invest in policies to encourage firms to enter the formal sector. For example, they may want to encourage formalization to increase the sense of rule of law, protect workers through greater compliance with labor regulations, increase the revenue collected through the taxation of firms, quickly disburse emergency relief to firms in times of recession or crisis, and prevent resources from being misallocated to informal firms [4]. In addition to targeted enforcement efforts, policymakers seeking to increase registration may also wish to explore how formalization interventions may be combined with additional incentives and services that help firms benefit from their formal status.

Sector chair(s) or Academic lead(s)

David Atkin Jing Cai Nicholas Bloom

Insight author(s)

Gaelle Conille

Siena Harlin

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2. Informal firms are often at a disadvantage in selling to tax-paying formal firms as the former cannot receive a value-added tax rebate when doing business with unregistered firms. For example, Gadenne, Nandi, and Rathelot (2022) document substantial supply chain segmentation between VAT and non-VAT-paying firms in India.

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4. It is important to note two caveats regarding existing research on informality: 1) most studies lack the statistical power to identify any impact of formalization on firm performance because the take-up of the intervention is generally low, and 2) among those studies that detect some positive impacts, the effect is mainly driven by relatively bigger informal firms.

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