Enterprise Formalization: An Introduction

Thematic Brief 1/2021

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An Introduction

This is an introduction to a series of briefs on enterprise formalization, which look at the costs and the benefits of transitioning to the formal economy, from the point of view of the enterprise, and present an overview of some of the measures that can be taken to support formalization. This introduction provides a definition of informal enterprises, discusses the different types of informal enterprises, and explores some of the most significant drivers to be or remain informal. The brief also explains why it is important for countries to facilitate enterprise formalization, how it contributes to decent work and what kind of strategies may be effective.

Other briefs in the series look at a subset of costs and benefits to enterprises of transitioning to the formal economy, including entry costs and ongoing compliance costs (Thematic Brief No. 2/2021) and taxes and social security contributions (Thematic Brief No. 3/2021). Each brief illustrates the ways in which enterprise formalization strategies can change the (perceived) costs and benefits of informal enterprises, thereby encouraging entrepreneurs to formalize. The briefs also provide recommendations for governments and social partners on how to contribute to formalization.

Acknowledgements
This Thematic Brief was developed by the ILO Small and Medium Enterprises Unit. The authors would like to thank Quynh Anh Nguyen, Kareem Bayo, Christina Behrendt, Florence Bonnet, Severine Deboos, Jens Dyring Christensen, Annie van Klaveren, Josée Laporte, Philippe Marcadent, Virginia Rose Losada, Miguel Solana and José Luis Viveros for their valuable inputs and feedback.
What are informal enterprises and why do we care about them?

Definitions of informality have evolved over time. The term *informality* was coined in the early 1970s, following the work of anthropologist Keith Hart on “informal income opportunities and urban employment in Ghana”. Hart observed that Accra’s urban poor were not unemployed, as some development practitioners believed them to be, but were “definitely working”, albeit “casually, for erratic and generally low returns” (Hart, 2008). There was a need for a new term to describe such work, which is distinct from the highly regulated contractual relationships between legally incorporated entities and their employees.

The Resolution concerning statistics of employment in the informal sector\(^1\) classifies enterprises as *informal* based on their levels of compliance with legal registration and record-keeping requirements. The international standards adopted at the 15th International Conference of Labour Statisticians further define the informal sector as consisting of enterprises involved in the production of goods or services with the primary objective of generating employment and earnings for the individuals involved. The informal sector is a subset of unincorporated enterprises not constituted as separate legal entities independently of their owners (ILO, 1993). Despite the existence of these statistical criteria, governments may apply different ways in which they measure informality, which creates challenges for cross-country comparisons of national estimates.

Today, the term *informal economy* has come to represent economic activities which take place beyond the reach of the State. The General Conference of the International Labour Organization adopted Recommendation 204 on the Transition from the Informal to the Formal Economy (henceforth ILO R204) in 2015. It refers to the informal economy as follows:

> “For the purposes of this Recommendation, the term ‘informal economy’: (a) refers to all economic activities by workers and economic units that are - in law or in practice - not covered or insufficiently covered by formal arrangements; and (b) does not cover illicit activities...”\(^2\)

In some cases, informal actors do not comply with the laws and regulations which formal firms and workers have to comply with, including labour and social security laws, health and environmental regulations and tax obligations. In other cases, they are not covered by those laws and regulations, which limits not only their duties but also their protection.

Recommendation 204 provides guidance to Members to:

- **a)** facilitate the transition of workers and economic units from the informal to the formal economy, while respecting workers’ fundamental rights and ensuring opportunities for income security, livelihoods and entrepreneurship;

- **b)** promote the creation, preservation and sustainability of enterprises and decent jobs in the formal economy and the coherence of macroeconomic, employment, social protection and other social policies; and

- **c)** prevent the informalization of formal economy jobs.

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1 The Resolution was adopted by the Fifteenth International Conference of Labour Statisticians (January 1993); 15th International Conference of Labour Statisticians. See: https://www.ilo.org/wcmsp5/groups/public/---dgreports/---stat/documents/normativeinstrument/wcms_087484.pdf

2 The concept of informality does not apply to unlawful activities, in particularly the provision of services or the production, sale, possession or use of goods forbidden by law, including the illicit production and trafficking of drugs, the illicit manufacturing of and trafficking in firearms, trafficking in persons and money laundering, as defined in the relevant international treaties.
In this context, the term **economic units** refers to:

a) units that employ hired labour;

b) units that are owned by individuals working on their own account, either alone or with the help of contributing family workers; and

c) cooperatives and social and solidarity economy units.

This brief refers to **economic units**, including own-account workers with no employees, as **enterprises**. **Formal** enterprises are those that produce goods or services (at least partially) for sale or barter, are registered at relevant national institutions (including social security and tax authorities) and/or maintain a set of accounts required by law. Those enterprises that do not keep formal accounts and are not registered at national level are, by contrast, considered **informal**.

Two concepts are applied to describe different incidences of informality. **Informal employment** is a broader concept that includes not only employment in the informal sector but also informal employment in the formal sector or in households. While the **informal sector** is defined according to the characteristics of the enterprises in which economic activity takes place, **informal employment** refers to the nature of the employment relationship (ILO, 2019a).

Most of the world’s population work in the informal economy, especially in developing regions. The ILO estimates that two billion people (aged fifteen and over) work informally, representing 61.2 per cent of global employment.

**Figure 1**: Distribution of employment by sector (formal versus informal) and economic unit size, across country income groups (%)

![Distribution of employment by sector](image)

**Source**: ILO, 2018b; ILO, 2019a.

The term 'self-employed' refers here to independent workers without employees.
What are informal enterprises and why do we care about them?

Workers can be grouped in different categories such as employees, independent workers, contributing family workers and dependent contractors. Independent workers without employees (also called own-account workers) make up 45 per cent of informal employment, whereas employees in informal employment in formal or informal enterprises or in households make up 36 per cent of informal employment. The remaining segment consists of contributing family workers (16 per cent) and employers (3 per cent).

Eight out of ten (81 per cent) of the world’s economic units are informal, and most informal employees are employed by informal enterprises. These informal enterprises tend to be for the most part small economic units: micro enterprises (including own-account workers) and small enterprises (see Figure 1 and ILO, 2018b).

The employment share of the informal sector is strongly related to country income levels, ranging from 85 per cent for low-income countries to 18 per cent for high-income countries. The high-income group is the only group where employment in the formal sector exceeds that in the informal sector (see Figure 2 and ILO, 2019a). This evidence reveals that a large part of the world’s population relies on informal employment for their livelihoods.

Globally, informality is more prominent among men than women, yet there are regional differences. In the Arab states and Asia and the Pacific, the share of men engaged in informal employment (including agriculture) is higher than that of women (70.2 per cent men compared to 61.8 per cent women in the Arab States; 70.5 per cent men compared to 64.1 per cent women in Asia and the Pacific). In Africa, the share of women engaged in informal employment exceeds the share for men (89.7 per cent of women compared to 82.7 per cent of men). Yet in all regions, women in informal employment are more often found in the most vulnerable situations (ILO, 2018b).

Enterprise formalization can pave the way for the formalization of jobs in these enterprises. It can also ensure fairer competition among enterprises, increase government revenues and contribute to national economic growth and social cohesion. As such, policy attention is needed to support a transition to formality, and
formalization is a means to achieving broader societal goals.

It is crucial to understand the diverse nature of informal enterprises, the drivers of informality and the reasoning behind individual decisions to set up a formal or informal business. Enterprises exist along a continuum, from those that are fully formal, covered by national laws and regulations and/or compliant with the legal requirements established by governments, to those that are entirely beyond the reach of the authorities, with many falling somewhere in between. An enterprise may be listed in the national business registry, for example, but not be registered for tax purposes; the same business may have formal employment contracts with some of its workers and make social security contributions, while keeping other workers (or a portion of its formal employees’ work-hours) off the record.

In a given economic and institutional context, the degree to which an enterprise may be able to formalize depends on various aspects such as the size of the enterprise, its productivity, the costs of operating in the formal sector, the ease of registering a business, the capacity and decisions of the business owner, as well as personal characteristics such as age, experience, income and education level, sector and workplace location. Survivalists, for example, have limited skills and competencies, barely generate enough revenue to make ends meet, and engage in livelihoods activities to sustain themselves and their families. Since regulatory compliance entails at least some monetary and/or non-monetary costs, formality tends to be beyond the reach of survivalist entrepreneurs. Opportunity entrepreneurs, by contrast, have the competencies and skills to run a profitable enterprise.
Why is enterprise formalization important?

Enterprise formalization strategies can make a substantial contribution to fulfil the Decent Work Agenda and achieve the Sustainable Development Goals. The informal economy is a major source of livelihoods for a sizeable proportion of the world’s population. However, a large majority of the global workforce faces serious decent work gaps. These workers cannot count on access to health care and at least a basic level of income security, and thus, do not enjoy their human right to social security. Many of these workers are locked in a vicious cycle of vulnerability, poverty and social exclusion, which constitutes an enormous challenge not only for their individual welfare and their enjoyment of human rights, but also for their countries’ economic and social development.

From the point of view of governments and society as a whole, an untaxed and unregulated informal economy reduces the tax base and therefore makes it harder to provide the public goods, services and policies that citizens expect, and to create a culture of compliance and social cohesion. From the point of view of formal workers and enterprises, the existence of an informal economy leads to unfair competition. And from the point of view of informal enterprises themselves, informality is associated with the risk of detection by law enforcement officials and often constitutes an obstacle to growth, as it makes it more difficult for them to access formal finance, business development services, technologies and investments. It also limits opportunities to do business with formal enterprises as informal enterprises do not meet compliance standards (e.g. in terms of tax registration and invoicing, decent work, etc.).

A shift towards greater formalization can benefit society as a whole, through better working conditions and decent work opportunities, a more productive workforce, better regulated economic growth, a more level playing field for competitors and a broader tax base that contributes towards the provision of public goods such as healthcare and education.

Many governments have sought to achieve the goals of enterprise formalization through the imposition of punitive measures on informal enterprises (e.g. fines, confiscation, forced closure). This may be appropriate in the case of larger businesses that have the capacity to comply with the law, but deliberately choose not to do so, in order to avoid taxes or reduce their costs in illegal ways. Smaller, less productive enterprises, however, may not be covered by regulations. When they are covered by such regulations, they may not be able to comply with them, even if they wanted to. Enforcement and punitive measures can cause these informal enterprises to close down and

Differences between formal and informal enterprises - and between different types of opportunity entrepreneurs, own-account workers and micro- and small enterprises - are closely related to productivity. Informal firms are, on average, much less productive than their formal counterparts, have lower margins, tend to operate in over-saturated markets and are often unable to absorb significant compliance costs. Low productivity is not only a driver of informality. It may also be a consequence of the informal status of the enterprises. Productivity enhancement is therefore an essential aspect of an enterprise formalization strategy.

Moreover, structural macroeconomic issues are important drivers of informality that go beyond the realm of single economic units. One may think of issues such as patterns of growth and general composition of the economy, the inadequacy of the legal and regulatory framework, lack of transparency and trust between administrative institutions and the society. Therefore, it is important to contextualise the causes and drivers of informality from a transversal perspective under which enterprise formalization marks one significant component.

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deprive informal workers of their livelihoods. It is therefore important that enterprise formalization strategies introduce a balanced mix of policies and interventions that are tailored to the nature and constraints of the different sub-segments of economic units. Such interventions should rely on effective targeting and address the identified drivers of informality among the economic units in each sub-category. Overall, it is recommended that enterprise formalization approaches combine measures to make it easier and more attractive to formalize with initiatives to increase productivity and enhance compliance, based on a process of social dialogue (see Figure 4).

How to facilitate the transition to formality?

**Enterprise formalization efforts need to be backed up by policies that promote worker’s rights, private sector development and social cohesion.** One of the main objectives of enterprise formalization is to ensure that workers (including employers, employees, own-account workers and contributing family workers) can benefit from decent work opportunities. Social protection policies should ensure that social security contributions are aligned with the contributory capacity of the enterprises, and that the quality of social security benefits (e.g. health, pensions, unemployment insurance) and related services is sufficiently high to meet the needs of workers and their employers (ILO, 2019b). The formalization of small enterprises also goes hand in hand with a conducive business environment and economic growth. Enterprise formalization strategies must be based on a process of social dialogue among employers’ and workers’ organizations and the government. They need to be framed within the overall context of social policies and private sector development strategies which aim to increase enterprise profitability and sustainability, enable capital accumulation and reinvestment in technology and workers’ skills development, strengthen social security and enhance workers’ rights and decent work. Policies that affect productivity, such as education, skills, technology development, research and innovation play an important role in this regard. Policy support, in this context, must be targeted at both informal and formal enterprises to prevent unfair competition between economic actors on different points along the informal-formal continuum (sometimes referred to as the parasite effect of informality), to facilitate the informal enterprises’ transition to formality and reduce the risk that formal enterprises shift into informality.
Enterprise formalization strategies should be adapted to specific contexts and approaches should be tailored to the needs and characteristics of the economic units, based on an assessment of their readiness to formalize (see Figure 5). Prospects for the transition from the informal to the formal economy, as envisaged in ILO R204, clearly depend on the profile of the informal enterprises that are making the transition. This profile may vary from one country to another, or even between sectors or regions within a country. In some cases, the stock of informal enterprises may consist primarily of survivalist entrepreneurs, operating at subsistence level and selling to low-income consumers in exchange for cash. According to the dual economy view of informality, formal laws and regulations are often too far removed from the realities of this economic segment, and the enterprises are therefore less susceptible to formalization. Organizing these economic units and reducing decent work deficits can create conditions to formalize in the longer term. Those opportunity entrepreneurs that are informal, on the other hand, might be ready to move into the formal economy if it becomes profitable for them to do so, according to the romantic view of informality popularized by de Soto (1989). In these cases, governments are called upon to develop and implement an integrated policy framework to facilitate the transition to the formal economy, recognizing that decent work deficits are most pronounced in the informal economy. The development of appropriate strategies and the identification of target beneficiaries is by no means a simple task; it requires policy makers to collect data on, and consult, members of society that are often hard to reach and reluctant to engage with the State. Research further suggests that supporting the formalization of enterprises when they are being established might be easier than formalizing existing enterprises that have been in operation for a while6.

Formalization efforts may focus on cutting red tape and adapting taxes and social charges to the payment capacity of the target group, as well as offering productivity-enhancing services such as finance, business development services and market linkages. Local governments play an important role in this regard as they are at the forefront of implementing formalization policies and facilitating access to support services. It is therefore important to prepare government officials to address the problem and build trust among informal actors, ensuring that the formalization effort will be based on a consultative process that takes their interests into account and where benefits of formalizing are made clear, and apparent.

Once a diagnosis of the nature and drivers of informality has been completed for a specific context, the next step is to develop a formalization strategy that is tailored to the targeted segment of enterprises (see Figure 5). In some cases, for example, policy makers may choose to adopt the cost-benefit approach, which compares the costs and benefits of remaining informal versus the costs and benefits of operating in the formal economy, from the point of view of the enterprise (see Figure 6). This approach is built on the idea that formalization should become more attractive and operating informally should become less attractive. In this framework, formalization is associated with monetary and non-monetary costs, including entry costs (business registration, tax registration, licensing) and recurring compliance costs (e.g. tax and social security contributions, annual tax declarations, renewal of licenses). Monetary costs are usually lower than the overall costs incurred by the enterprise; the remainder is made up of non-monetary costs, including the time and effort required to understand applicable regulations, to prepare and submit documents, to undergo the relevant procedures and comply with the law. On the other side of the equation, the benefits of formalization may include: social security coverage for the entrepreneur and the family, as well as the workers; access to finance and business development services; access to foreign markets; increased productivity; the ability to issue invoices and the resulting opportunity to reach customers in formal markets; eligibility to participate in public tenders; the legal status required to sign contracts and enforce them through the legal

system; and freedom from the risk of having to pay penalties for non-compliance or having the business closed down. Those entrepreneurs that are - in principle - able to comply with the law, will choose to formalize if the (perceived) net benefits of formalization outweigh the monetary and non-monetary costs of operating informally, including the risk of penalties as a result of detection by law enforcement officials.

Governments should not only assess the costs and benefits of informality for the individual, but also consider the costs of informality for the society. This is very important, as the decision whether or not to formalize does not only affect the entrepreneur. It also affects the society. The externalities of informality should be factored in when developing enterprise formalization policies.

**Figure 5: Formalization pyramid**

Targeting economic units differently

Various factors can cause formalized enterprises to become informal which often leads to a deterioration of decent work conditions.

The middle segment is mainly characterised by ‘opportunity entrepreneurs’ who, in principle, have the entrepreneurial means to formalize.

For many in this segment, interventions should focus in the short-run on reducing decent work deficits, as a first step toward possible formalization in the long run.

**Source:** ILO, 2020.

**Figure 6: Costs and benefits of formalizing an enterprise**

<table>
<thead>
<tr>
<th>COSTS</th>
<th>BENEFITS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entry costs</td>
<td>Access to social security</td>
</tr>
<tr>
<td>Ongoing compliance costs</td>
<td>Access to (public &amp; private) markets</td>
</tr>
<tr>
<td>Taxes</td>
<td>Access to finance</td>
</tr>
<tr>
<td>Social security contributions</td>
<td>Access to business development services</td>
</tr>
<tr>
<td></td>
<td>No more penalties for non-compliance</td>
</tr>
</tbody>
</table>

**Source:** ILO, 2020.
Further reading/resources


Enterprise Formalization: An Introduction
Thematic Brief No. 1/2021

Enterprise Formalization: Simplifying and facilitating business start-up and compliance
Thematic Brief No. 2/2021

Enterprise Formalization: Tailored registration, tax and social security requirements for MSEs
Thematic Brief No. 3/2021