

Approaches to Reducing Firm Informality

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The Exit and Exclusion Viewpoints

- *Exclusion* – sees informality as a result of cumbersome regulations and bureaucracy

⇒ Solution is regulatory reform efforts/making it easier to formalize

- *Exit* - smaller and less productive firms rationally opt out of formal sector because they see little benefit to becoming formal

⇒ Solution: efforts to increase productivity of firms, and change the cost-benefit calculation

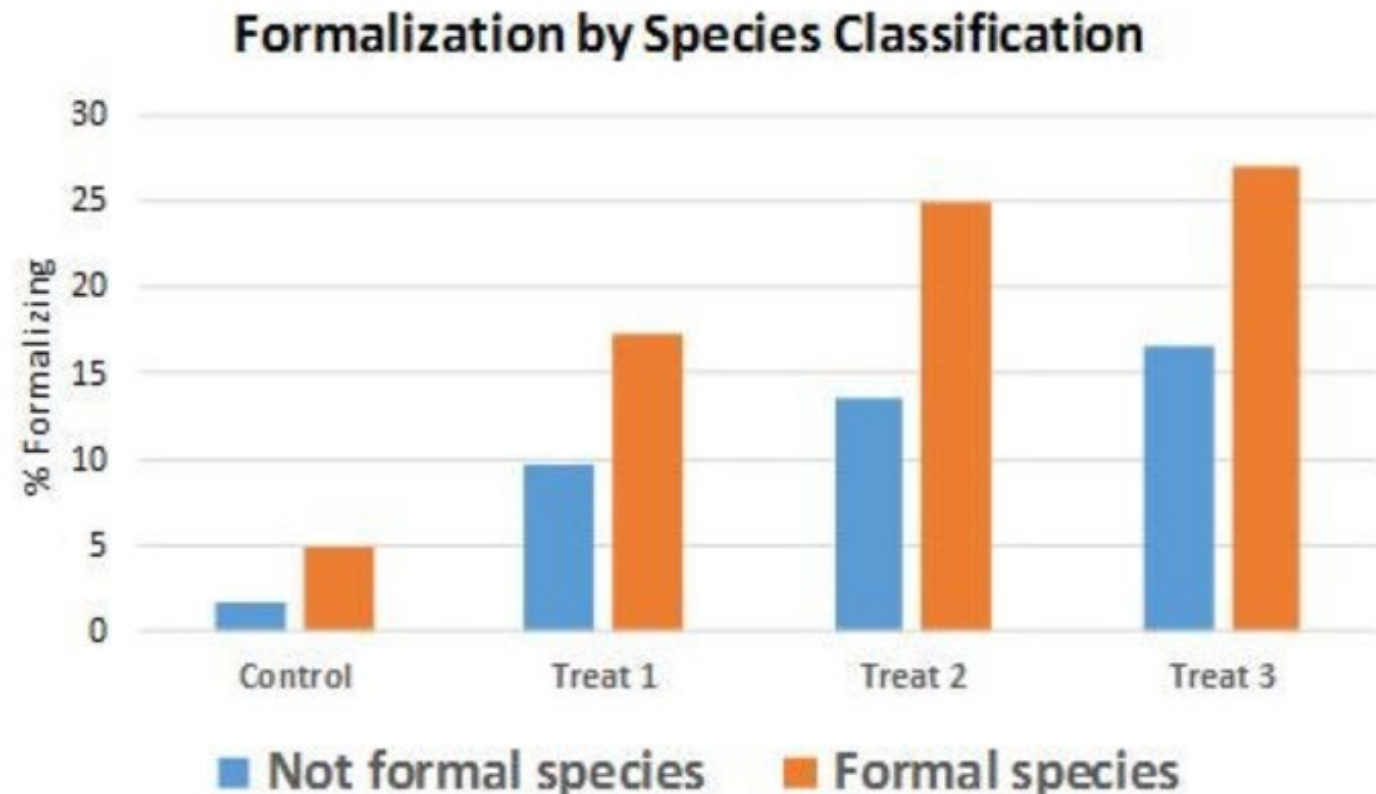
Key point: *Informal sector is very heterogeneous and the reasons you might firms to become formal can differ* – don't want one-size fits all policy.

Evidence on regulatory reform efforts

- Many regulatory reform efforts around the world simplify the process and costs of formalizing
 - Beneficial for those firms that were going to become formal anyway
 - But in practice only has very limited impact on how many informal firms formalize
- May need to do more – just doing reform and providing information does not do much
 - Adding additional assistance and benefits increases formalization, especially for those firms that look more like formal firms to begin with.

Example: Entreprenant reform in Benin

- New simplified status introduced, experiment with 3600 firms
- Treat 1: in-person visit + help to register
- Treat 2: + access to govt Training programs & banking
- Treat 3: + support dealing with taxes



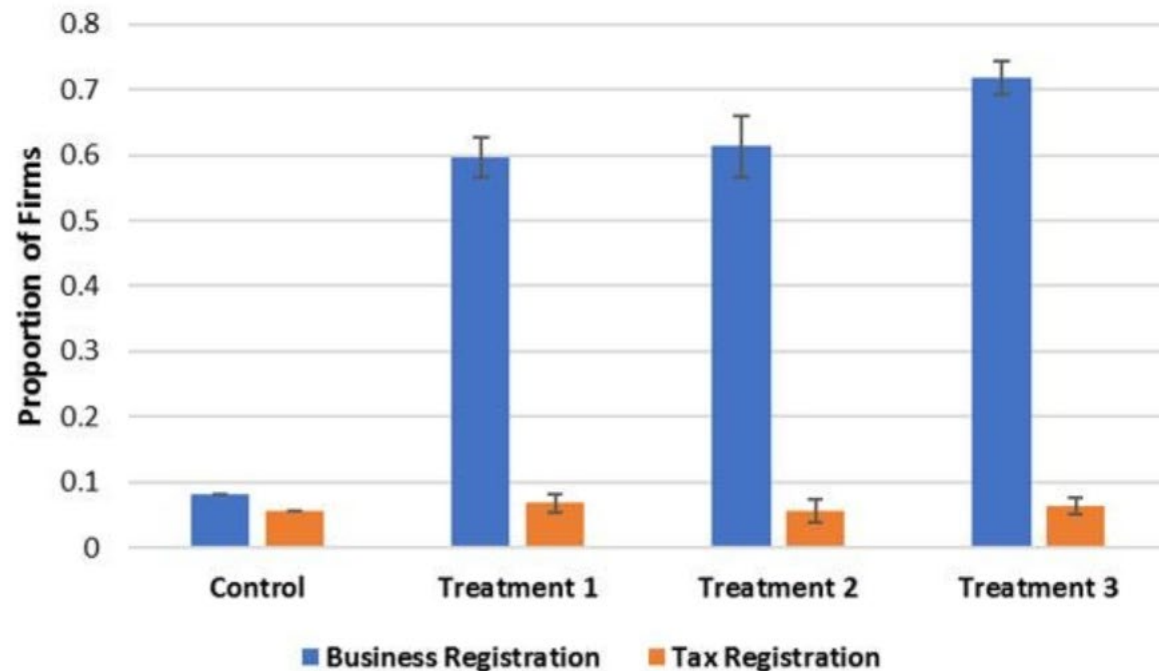
Is formalizing worth it to firms?

- Experiment in Sri Lanka – helped firms to formalize through information, and then providing financial incentives up to 1-2 months profits
- Most firms see no benefit from formalizing – only a handful of firms earn more profits – by getting insurance contracts, services to sell to government

Firms may wish to become partially formal

- Malawi – business name registration vs tax registration

Figure 1: All three treatments increased business registration but not tax registration



Does formalizing pay? Only for those who also get bank information session and business banking assistance = benefits of formalizing not automatic.

Enforcement vs Assistance

- In Belo Horizonte, Brazil, we tested sending inspectors vs information and lowering costs
 - No impact on formalizing of information and lowering cost of registering
 - One additional inspection led to 21-27 percentage point increase in municipal registration
- Ideally want to target enforcement at larger, more profitable informal firms
 - Progressive tax system would not want to collect much from smaller informals anyway.

The role of trade in reducing informality

- Vietnam Bilateral Trade Agreement expanded market access for Vietnamese firms by lowering the US tariffs on their exports
- Small informal firms too small to directly benefit and be able to export, it was the bigger firms that expanded
- These large firms pulled workers from the informal sector, shrinking the informal sector

i.e. mechanism is not getting the informal firms to become formal, but supporting growth opportunities for larger, formal firms, which can expand and start hiring workers from the informal sector.

- Still lots of data gaps – harder to follow informal firms over time with trade policy changes.