How to Encourage Enterprise Formalization: Some Practical Hints for Policymakers in Africa
by Thomas Kenyon

How and why do firms become ‘formal’?

What, if anything, can or should policymakers do to encourage enterprise formalization? These are important questions. Some estimates suggest that over 30 percent of output and 70 percent of workers in developing countries are to some degree outside the scope of government regulation. In Africa the figures are even higher. Most people also agree that these proportions are rising over time – contrary to the predictions of development specialists some decades ago, who assumed that informality would disappear in the course of economic modernization.

There is much less agreement over what to do about informality. It is not necessarily harmful, either to individuals or to societies. Even relatively developed countries sustain quite large grey or shadow economies. Some argue that informality may be a natural state of affairs, particularly for the very poor, the self-employed or those engaged in subsistence agriculture. Informality may also be a coping mechanism or legitimate response to corrupt or inefficient regulation: states that have little to offer cannot expect much in return. Others take a different view. Many practitioners have emphasized the possible untoward effects of regulatory and tax evasion on growth and productivity. Informal enterprises, they say, compete unfairly with formal ones and can deter them from investing and expanding. For them, formalization is a necessary part of private sector development.

Policy-makers should start by recognizing that the ‘informal sector’ is large and heterogeneous. It encompasses all sorts of activities from the self-employed to small businesses employing a handful of workers to quite large enterprises. No doubt some informal enterprises would disappear if forced to comply with government regulation. On the other hand, there are also many enterprises for which the benefits of formal status are likely to be large and many informal sector operators say they want to formalize. The first task is to identify those informal firms for whom participation in state-sponsored institutions makes most sense, or whose activities impose significant costs on the rest of society. These are likely to be more prevalent in middle income countries with relatively well-functioning formal sectors than in low income countries. They may also be clustered in particular sectors – those which require significant fixed investments, for instance, or with export potential.

This policy note takes as its starting point the common view that there are benefits and costs to formal status and that formalization will occur only if entrepreneurs perceive it to be in their self-interest. No doubt part of the answer lies in reducing the costs and time required for compliance— as the World Bank’s Doing Business project has documented. But lowering

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1 Schneider estimates the informal economy at over 20 percent of official GDP in Belgium, Greece, Italy, Portugal and Spain.
2 An IFC survey of Sierra Leone, for example, found that 80 percent of informal entrepreneurs had considered formalizing their businesses in the previous year but had been deterred for whatever reason. Another study of informal firms in South Africa found that only 24 percent thought their present level of compliance was sufficient, meaning they saw no disadvantage in informal status.
barriers to entry is unlikely to be sufficient. Encouraging formalization requires us to understand the relationship between state and private business as a bargain. And it also challenges policy-makers and development practitioners to think not only about technical solutions but also about institutional mechanisms for improving relations between entrepreneurs and the state.

What then are the difficulties involved in enterprise formalization and what are some of the practical steps that well-intentioned policy-makers can take to promote it?

Exchange information and build credibility:

The first issue is information. In many if not most cases, entrepreneurs lack even the most basic knowledge about how to regularize their enterprises or of what they might stand to gain from doing so. An IFC survey of informal operators in Sierra Leone, for instance, found that respondents viewed lack of information as the most serious obstacle to obtaining a license – well ahead of the monetary costs or time involved. A 2001 Tanzanian government tax simplification program failed in large part because the authorities did not inform entrepreneurs about the change.

Not only do entrepreneurs lack information about how to regularize their businesses, but also government agencies often lack information about the nature and scale of unregistered or otherwise unregulated economic activity. This is partly because many though not all unregulated firms are small and geographically dispersed. Also, government employees often lack a common understanding and culture with the people whom they are attempting to regulate. 3

Another issue is credibility. Many informal operators are reluctant to disclose their activities to the authorities, because they fear they will be extorted for bribes. Or they may feel that they will get nothing in return for their cooperation. Often this caution is well-placed. In Morocco in 1998, for example, informal traders were encouraged to register by the promise of a tax amnesty. Once they had registered, however, the local government in Marrakech charged them four times the promised amount and required them to pay back taxes for the previous five years. These concerns can be magnified by the marginalization of informal operators—who may lack the political clout of more formal firms. 4

Understand incentives:

Policymakers need to understand exactly what informal entrepreneurs stand to gain from formalizing. The benefits of formalization are specific to each particular activity:

- **Artisanal miners** can receive a steady income, market their resources at a higher price and ensure that they are treated fairly.
- **Small-scale service providers** can ensure that they are paid for their work.
- **Agricultural producers** can gain access to the market.

One of the tricks to building reciprocity – or an exchange relationship – lies in linking the benefits and costs of compliance. Policymakers are often cautious about linking market access to registration or other bureaucratic requirements. They feel that markets should be open to all, irrespective of status. There are also practical problems. In Sudan, for example, the central government required entrepreneurs to obtain clearance from the tax authorities before they could renew their licenses, but local authorities who collected the fees objected because it deterred enterprises from registering.

Nonetheless, it is worth thinking creatively about how to connect the costs and benefits of compliance – otherwise the incentive to

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3 As Ghanaian political scientist Joseph Ayee has put it, ‘patrolling poorer areas to identify tax evaders…is a thankless task…[E]ducated tax officials dislike interacting with illiterate, poor, disenchanted and sometimes violent citizens who dislike being harassed for taxes when they are attempting to eke out a meager living.’

4 This is not to say that informal entrepreneurs are always politically marginalized: in some cases local politicians and entrepreneurs have been very effective at constructing what economist Judith Tendler has called a ‘Devil’s Deal’ – ‘If you vote for me…I won’t collect taxes from you; I won’t make you comply with other tax, environmental or labor regulations; and I will keep the police and inspectors from harassing you.’
regularize will disappear. There are various ways of doing this. In one case, an African government worked with commercial banks to persuade them to lower their cost of lending to enterprises that had committed to formalization. In another, a revenue authority allowed newly registered firms to charge higher VAT rates on their products than those they paid to their suppliers – effectively giving them a tax break. Another approach might be to use pooled data on registered enterprises to make it easier for individuals to get access to, for example, health insurance or other services.

Work through intermediaries:

It is almost impossible to formalize unorganized informal sector enterprises. The best approach is to work through existing informal organizations – individuals or associations with one foot in the informal and the other in the formal sector.

The advantage of working through intermediaries is that they are generally more credible than governments, have closer knowledge of conditions on the ground, and may be better placed to enforce bargains – providing selective benefits to those who choose to formalize. They are also well-qualified to set common industry standards and identify and punish individuals who fail to meet them. The latter ability is very important in export clusters, where even a single breach can undermine an industry’s reputation. Finally, informal sector organizations are also in a position to package information about their members and provide it to commercial banks or other service providers at a lower cost than if these outsiders did it for themselves.

The usual candidates for this intermediating function are business associations. There are several cases from developed countries, for example Italy, in which artisans’ associations persuaded their members to regularize by providing business development services, such as accounting and help with tax returns. In Kenya the association of small tea-growers helped its members’ compliance with national product standards by acquiring inputs, such as pesticides and fertilizers, in bulk and selling them at a discount to producers. Another possibility is to work through trade unions. In Ghana the Passenger Road Transport Union has collected taxes from its members on behalf of the state for the last twenty years – in exchange for 2.5 percent of the revenue raised. This arrangement worked well for many years, though the union became gradually less assiduous in handing over revenue to the government than it should have been.

Other potential partners include large formal firms – either individually or as part of an export processing zone. Examples include Mittal Steel in Liberia and Mozal in Mozambique. But the role is not restricted to multinationals – domestic formal firms can be useful as well (see box). In countries where private sector activities have been disrupted by conflict, it can be advantageous to work with enterprises that were previously formal and that retain a ‘memory’ of what it is like to operate within a regulated system.

**We should not be too optimistic.** As in developed countries, most business associations in the developing world are dominated by large, politically well-connected firms who have little interest in engaging with informal enterprises, which they often regard as a nuisance and a source of unfair competition. And formal business associations tend to be organized horizontally rather than vertically, with few channels of communication between buyers and suppliers. This can be a problem, given the need for compliance at all points in the export chain.

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**The Role of Large Firms:**

**Pêcheries Frigorifiques du Sénégal**

In Senegal there are around 325,000 artisanal fishermen who together provide the country’s largest source of foreign exchange. Pêcheries Frigorifiques du Sénégal, a locally-owned fish wholesaler selling to European markets, has worked closely with informal suppliers to help them meet export standards. For instance, the company provided these suppliers with ice so that their catch would not spoil en route to the processing plant and issued invoices on their behalf to keep track of production.

During the 1990s the industry more than tripled in size, helped in part by the devaluation of the Senegalese currency in 1994. Unfortunately the industry failed to heed warnings about overfishing and has consequently shrunk by half in the last five years.

The Senegalese experience shows the value of collaboration between formal and informal enterprises for securing market access via upgrading, but also illustrates its limits – especially in industries that require careful resource management.
Business associations in developing countries are also often preoccupied with donor concerns, to the detriment of an independent policy agenda. They may be subject to meddling by local politicians. In Kenya for example the Moi government encouraged the formation of ‘jua kali’, or informal sector groups, in the early 1980s, only to backtrack out of fear that the groups might emerge as a rival political force. There are also potential pitfalls associated with relying on larger companies. Multinationals tend to depend on outside suppliers and may be reluctant to source locally unless they are contractually obliged to, like Mittal Steel in Liberia. Conversely local suppliers may think twice before tying their fortunes to a single buyer.

Formalization is not painless – and must be carefully managed:

The transition from informality to formality is not painless. Enforcing rules, even when they are well-designed, is likely to cause disruption in the short term. One of the defining characteristics of competitive capitalism, after all, is exit as well as entry. The costs are likely to be even higher if the process is poorly managed. It is preferable to begin with those for whom the potential benefits are highest and even then to emphasize the carrot at the expense of the stick, at least at first. It may also make sense to refrain from taxing formalizing firms at the outset – concentrating instead on building a relationship with informal entrepreneurs and allowing them to develop a sense of what it means to operate within a regulated system.

Six practical lessons for governments

1. **Simplify and coordinate**: Streamline registration and tax requirements to achieve well-defined, limited objectives, lower the costs of compliance and avoid enforcement efforts by one agency that work against the objectives of others.
2. **Inform**: Develop transparent guidelines to clarify rights and obligations of entrepreneurs; organize awareness campaigns via TV and radio.
3. **Build trust**: Encourage public-private dialogue involving representatives from the informal sector and informal sector associations.
4. **Work through intermediaries**: Potential partners include business associations (formal and informal) and large formal firms.
5. **Provide the right incentives**: Think creatively about linking costs of formalization to tangible benefits (e.g. market information, skills & training, access to finance).
6. **Sequence carrots and sticks**: Once enterprises have become accustomed to regulation, concentrate more on enforcement (if necessary through naming and shaming).

**FURTHER RESOURCES:**


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This policy note is based on a survey of the academic and policy literature and on the reflections of participants of a World Bank Group sponsored conference on enterprise formalization in Accra on January 10–11, 2007.

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