Helping Firms Realize the Benefits of (Partial) Formalization
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Developing country governments seek to reduce pervasive informality of firms for multiple reasons: increasing the tax base, helping firms access formal markets and grow, increasing rule of law, and as a means of obtaining data that can be used for other government functions.

The most common approach towards achieving these aims has been to make it easier for firms to formalize, most notably by setting up one-stop shops where firms can register as a legal entity and for tax purposes all at once. But past experiments have showed very few informal firms choose to formalize even after such reforms, and that many of those who do fail to see any benefits on financial access or firm growth.

An alternative approach, used in much of Africa, is to separate the process of business registration from tax registration. Getting firms to register legally may help governments reduce informality and achieve some of the aims above, even if it does not raise more taxes. But the question is then whether firms are interested in even this more limited form of formalization, and whether they see any benefits from using it.

Becoming Formal in Malawi
As part of the Business Environment Strengthening Technical Assistance Project (BESTAP) supported by the World Bank, the government of Malawi reformed the process of registering a business, in the process making it faster.

Malawi, like much of Africa (apart from West Africa), separates registration of the business name (which gives the firm a business registration certificate), from registration for taxes. Many of the purported benefits of becoming formal only require business registration, such as opening a business bank account, registering land, and accessing government programs.

Starting with a listing of 100 business centers in the cities of Lilongwe and Blantyre, in early 2012 we conducted a baseline survey of 3,002 informal firms, over-sampling female-owned firms so that 40% of the sample were female-owned.

Experimental Design and Intervention
We randomly divided this sample into the following three treatment groups and a control group:

- **Treatment 1 - Business Registration Only**: assigned to receive costless registration for the business registration certificate (745 firms)
- **Treatment 2 - Business and Tax Registration**: assigned to receive costless registration for the business registration certificate, as well as for a tax-payer identification number (293 firms).
- **Treatment 3 – Business Registration and Bank Assistance**: assigned to receive costless registration for the business registration certificate, along with an invitation to information sessions at a bank where business bank accounts were offered (1,207 firms).
- A control group of 757 firms

The key idea behind treatment 3 is that the benefits of formalizing might not be automatic, but that firms may require additional assistance to be able to take advantage of their new status. The bank
information sessions took 20 hours over 3 days, teaching firm owners how to access and use business bank accounts, and helping them set one up.

We then measure impacts on formalization rates, access to finance, and on firm growth over four follow-up survey waves that enable us to track outcomes for three years after the intervention. Survey attrition rates were 10% or lower in each wave.

Results

• All three treatments lead to large increases in business registration, and almost no change in tax registration (Figure 1). The most effective, treatment 3, increased business registration by 64 percentage points.

Figure 1: Treatments Increased Business Registration but not Tax Registration

• The treatment impact on getting business registration was about 8 percentage points smaller for female-owned businesses, but still large and significant.

• The benefits of formalizing did not come automatically to firms who just received treatment 1 or 2. Only an additional 1 to 2 percent of these firms set up business bank accounts, and there was no significant impact on their profits or sales.

• In contrast, adding the bank information sessions enabled many more firms to get business bank accounts in treatment 3 (a 39 percentage point increase). This in turn helped the firms grow, with sales growing 20 percent and profits 15 percent (both statistically significant). This impact was similar in terms of the level increase in profits for both male and female-run businesses.

Policy Implications

1. This work shows that transaction costs are a primary barrier to business registration, with most informal firms choosing to register when this is made costless. However, almost no firms choose to costlessly register for taxes.

2. The benefits of formalizing do not come automatically to small firms, so coupling simplification efforts with assistance to help firms connect with financial institutions appears useful.

3. While many loan and business training programs have not succeeded in helping female-owned firms to grow, this combination of assistance to register and to access banks does offer promise.

4. This partial registration helps governments achieve three of the four aims of reducing informality: they help firms grow, make more firms compliant with the law, and get basic data on their firm sector. However, efforts to increase the tax base will require other interventions.


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