

Formalising the informal sector

Informality is an economic and social challenge in most countries, although it is often much less important in developed countries. Innovative enterprises may contribute to formalizing the informal sector in several ways. First, they are less likely to operate in the informal economy, as they have higher returns from operating in the official economy. Second, they may provide employment opportunities and innovations that encourage people and businesses to move from the informal sector to the formal sector. Yet there is a lack of evidence on the contribution of innovative entrepreneurship to addressing informality. Public policy can positively influence this contribution by supporting innovative entrepreneurs in general and, more specifically, those who may have the greatest impact on informality (e.g. social entrepreneurs). Policies supporting the formalization of businesses (e.g. reduction of the perceived cost from registration) may also be important complements.

What is informality?

The informal sector is defined as the set of **unincorporated enterprises owned by households**, which produce at least some products for the market and that are:

- **Informal own-account enterprises** (i.e., all, or those that are not registered under specific forms of national legislation);
- **Enterprises of informal employers** (i.e., all those with less than a specified level of employment and/or not registered and/or employees not registered [International Labour Organization, 1993]).

The informal sector is comprised of an “upper tier” and a “lower tier” (Fields, 2005). The upper tier comprises the workers who voluntarily choose to be informal and the lower tier consists of individuals who cannot afford to be unemployed but do not have access to more productive employment in either the formal or the informal sector.

The informally employed can further be classified into groups, based on the status of employment. Among those self-employed it is possible to distinguish: an entrepreneurial class among the self-employed, micro-entrepreneurs and own-account workers with no intention of, or scope for, potential growth, and unpaid family workers. Among informal wage employees there is also a wide range of workers, including regular wage employees in the informal sector, casual and day labourers in the informal sector, and other wage employees, including informal sector enterprises, without employment-based protection (Jütting and de Laiglesia, 2009).

Informality is often considered both a social challenge and an economic challenge. Informality is a social challenge because informal employment is often associated with low earnings, low-quality jobs and poverty (Jütting and de Laiglesia, 2009). Without access to social security mechanisms, informal workers are particularly vulnerable and face severe risks, particularly in times of crisis (OECD, 2012). Registration improves the work security of micro-entrepreneurs, increasing their ability to establish property rights over their investments and seek legal protection. Informality is also an economic challenge, as it affects public revenues and firm productivity. As a result of informality the tax base is small and high taxes have to be levied on a subset of firms, usually the most productive ones. Moreover, competition tends to be distorted in a business environment that does not sufficiently reward formalization.

The informal sector is a prominent characteristic of developing economies. Yet it is also an issue in developed countries, although usually much less important. Indeed, informality remains substantial in OECD countries where taxation gives professionals and entrepreneurs

significant incentives to work “under the radar” (Koettl and Weber, 2012).

How does innovative entrepreneurship contribute to addressing informality?

Innovative entrepreneurship can contribute to reducing informality:

- **Directly, as innovative entrepreneurs are more likely to operate in the formal economy than non-innovative entrepreneurs** (Jütting and Laiglesia, 2009). Indeed, two characteristics of innovative entrepreneurs are incompatible with informality: innovative entrepreneurs are growth-oriented and generally need to take full advantage of external resources, partnering with public, financial and education institutions. Thus, increasing incentives for the creation and development of innovative enterprises may lead to reductions in the informal sector.
- **Indirectly, by introducing employment opportunities and innovations that encourage people and businesses to move from the informal sector to the formal sector.** Innovative entrepreneurship can provide employment opportunities for disadvantaged individuals who may otherwise work in the informal sector. It can also introduce innovative products and services that increase the incentives for businesses to formalize and create new business opportunities in the formal sector (Jütting and Laiglesia, 2009; Pauvov, 2013). For instance, innovations that are made accessible to lower-income groups may encourage individuals who work in the informal sector to start innovation initiatives that would benefit from being in the formal sector (e.g. business opportunities based on the mobile banking service). Yet it seems quite unlikely that “subsistence” entrepreneurs in the informal economy will become transformational entrepreneurs (Schoar, 2010).

Evidence on contributions to addressing informality

Measuring the effect of innovative entrepreneurship on informality is difficult, given the complexity of defining and measuring the unofficial economy. Thus, evidence on the contributions of innovative entrepreneurship toward addressing informality is lacking. There is also limited evidence that the growth of the high-productivity sector may absorb labour from the unofficial sector, as the first economic models of informality suggested (Lewis, 1954). Over the last 30 years, growth in several Southeast Asia and Latin America countries was accompanied by increasing, not falling, informal employment (Jütting and de Laiglesia, 2009). This weak link between economic growth and informality is inconsistent with a view of workers in the informal sector queuing up for formal sector employment. However, numerous examples confirm the capacity of innovative entrepreneurship to offer employment opportunities to disadvantaged individuals, such as low-skilled young people and women (OECD, 2010, 2012) who are the most likely to work in the informal sector (Jütting, J. and J. de Laiglesia, 2009).

What is the role of policy to help innovative entrepreneurship address informality?

Public policy can influence the contribution of innovative entrepreneurship to informality by:

Supporting innovative entrepreneurs who may contribute the most to addressing informality (e.g. innovative entrepreneurs who employ people who would be the most likely to work in the informal sector, such as low-skilled young people and women who are over-represented among the informally employed). Support may take several forms, such as improved access to finance through the creation of fiscal incentives to attract investors, multiple forms of credit enhancement, seed funding programs, dedicated funds, risk-sharing arrangements between public

and private organizations, and public-private co-investment partnerships.

Complementing policies supporting innovative entrepreneurs with broader policies supporting the formalization of businesses in general. These policies can, for instance:

- **Increase the benefits from registration** (e.g. by improving access of micro-enterprises to formal loans, by subsidizing the hiring process for small new ventures).
- **Reduce the perceived costs of registration** (e.g. by reducing the time and cost of registration, decreasing corporate taxes). Evidence shows that reducing corporate tax rates and simplifying the paperwork for registration and tax compliance help in reducing informality. One-stop shop services for registration and tax payments, offering business support services to newly registered entrepreneurs, have also been found to be highly effective. In 2011, in Brazil, a total of 1.9 million micro-entrepreneurs had formalized via the online portal one year after it was launched.
- **Increase the availability of information about the benefits of going formal.** Business associations and other representative groups can play a useful role in this communication effort. For example, to encourage people to register, SEBRAE (the Brazilian support service for micro and small enterprises) campaigns for and delivers capacity-building programmes.

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