



The Informal Economy: an Employer's Approach

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Executive Summary

The informal economy is one of the greatest economic development challenges facing societies around the world today. The informal economy, according to the International Labour Organization (ILO) is defined as the “economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements.”¹ Informality is complex, covering both individuals and businesses that work in the informal economy for many reasons. For some it is a survival strategy when formal work is not available, while for others it is a purposeful, self-interested decision. While discussions about informality often talk of either ‘formal’ or ‘informal’ in practice, many workers and businesses exist in a grey area between the two.

Informality is pervasive and its consequences are significant. An estimated 61% of the world’s working population make their living in the informal economy. It is concentrated in emerging and developing economies, which are home to 93% of all informal workers. It is closely linked with negative economic outcomes including poverty and low productivity. In emerging and developing economies, the average productivity gap between formal and informal businesses was estimated at 75%.² Informality can often entail greater financial risks for workers and businesses, or lower returns for their efforts. It can present additional challenges for women, especially in low-income countries where they are more likely to work informally and more likely to be contributing family workers, a vulnerable status with low or no pay.

Addressing informality requires broad consultation and an all-of-government approach across a wide spectrum of policy issues. The policy focus should include not only alleviation of the consequences of informality, but also steps to address its root causes, including but not limited to improvements in the business-enabling environment. Policies and programs to address informality should always retain a practical focus and be subject to regular impact assessments, while always being cognisant of the rights of workers. In all efforts to address informality, government should work with the private sector and its representative organization(s) as a key partner.

Reducing excessive regulation and bureaucracy is an important policy focus, as these can directly lead to informality by incentivizing businesses to avoid formal governance. It can also help to address the risks of corruption that often accompany excess bureaucracy. Business registrations could be reformed to ensure they are simple, transparent and automatic. Other start-up barriers, such as licenses, permits and minimum capital requirements, should also be right-sized. Other reforms that can help address informality include improving access to credit and property rights, as well as enhancing skills development and training.

Increased flexibility in the labour law framework can lead to increased formality and hiring, and could be accompanied by improvements in the labour administration system. These reforms should be complemented by a robust social protection

¹ International Labour Organization R.204. “Economic units” includes units that employ labour, own account workers (with or without their contributing family members) and cooperatives and social and solidarity economy units.

² World Bank

system that covers not only employees but all workers in the informal economy. While employers have an important role to play in supporting some costs of social protection, state support is also needed, especially to provide social protection for informal workers who do not have an employer. In all policy reforms, employers should constantly reinforce the importance of increasing productivity as the most important single goal that can reduce the root causes of informality.

Employer and business membership organizations (EBMOs) have an important role to play in addressing informality, through service provision, advocacy, research, and institutional support. Already, EBMOs advocate for some policies, especially those that improve the enabling environment, that can also help address informality. To further develop their work on informality, EBMOs can start by conducting additional research and analysis, starting with the state of the informal economy in their country context. This can include a review of data and surveys, a study of key policies shaping the informal economy, and an analysis of competition with the formal economy. EBMOs can also develop new services targeted directly at challenges in the informal sector, such as advisory services to informal businesses about formalization or training and advisory services to improve productivity. EBMOs could also use new services targeting informal businesses as a marketing tool, by using them as an entry point for new members to join the EBMO, perhaps under a streamlined membership package.

EBMOs should also develop an advocacy agenda about informality. This agenda should be guided by key principles, including a focus on realistic improvements and full consideration for the limited productivity of many informal businesses. Key policy areas for EBMOs to include in their advocacy agenda are business registration, taxation, and labour regulations. EBMOs may also consider pushing for expanding e-government or enhancing special financing programs targeting informal businesses. At all times, however, the policy proposals should be well-designed and suitable for the local context. Lastly EBMOs can play an important role supporting the development of organizations that work more closely with the informal economy, including but not limited to associations of informal businesses.

The International Organisation of Employers (IOE) encourages international institutions and governments to continue in their efforts to tackle informality. EBMOs are natural partners for these institutions and governments, and they share a common interest in addressing both the root causes and consequences of informality through practical, demand-driven policy solutions. Ultimately, the reforms needed to tackle informality must take place through national political processes led by national actors. National-level EBMOs are an essential actor in this process, with a distinct role as the legitimate representative of the business community and a clear commitment to improving economies and work around the world.

1. Preface

The informal economy is one of the greatest challenges to economic development facing societies around the world. Informality is pervasive. More than 60% of the world's workers are in the informal economy. They earn less on average than workers in the formal economy, and are also less productive. Addressing informality - both its causes and consequences – is an integral component of any strategy to promote sustainable and inclusive economic growth and development.

Individuals and businesses in the informal economy struggle to do business in a situation of legal uncertainty and insecurity, while they also face numerous economic constraints. Businesses face challenges with registration, taxation, labour regulations, and other areas. They struggle too with barriers to transactions, property rights, contracting, business identity, raising capital and trading. In essence, they struggle to have the official recognition of their property and business ownership. For billions of workers, informality means a lack of social protection, rights at work and decent working conditions, as well as significant uncertainty about their income and livelihood. The COVID-19 crisis has only amplified the pre-existing structural weaknesses linked to informality and highlighted the need to address them.

Transitioning from the informal to formal economy is challenging but international standards provide some guidance. ILO Recommendation (R.204) concerning the Transition from the Informal to the Formal Economy calls for “an integrated policy framework to facilitate the transition to the formal economy”, which combines a wide range of relevant policies in a coherent way. In addition, R.204 stresses the importance of developing context- and time-specific measures. National actors – governments, workers and businesses – are best placed to guide this transition in their own national contexts.

This paper identifies specific areas for critical action by employers, governments and the international community. It is primarily intended for employer and business membership organizations (EBMOs), especially in countries with high levels of informality. Its goal is to support the work of these EBMOs in tackling informality and supporting the formalization of workers and businesses.

2. What is the informal economy?

The “informal economy” is the part of the overall economy that happens outside the formal regulatory frameworks of government. The International Labour Organization (ILO) has defined the informal economy as “economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements.”³ The IMF has described the informal economy as unregulated activities in agriculture, retail trading and the gig economy and characterized it as a safety net for the poor and as having low incomes, low productivity and limited access to government benefits.⁴

³ International Labour Organization R.204. “Economic units” includes units that employ labor, own account workers (with or without their contributing family members) and cooperatives and social and solidarity economy units.

⁴ Video remarks by Kristalina Georgieva, Managing Director, IMF, <https://www.imf.org/en/News/Seminars/Conferences/2019/03/25/7th-statistical-forum>

⁵ Schneider, Buehn, and Montenegro 2010

The “informal economy” - which is often simply referred to as “informality” - has also simply been defined as the “market-based and legal production of goods and services that is hidden from public authorities for monetary, regulatory, or institutional reasons.”⁵ As this last definition notes, the informal economy is generally distinguished from the illicit economy, excluding activities such as the production of drugs. For workers, informality can include self-employment as well as informal employment at either formal or informal enterprises. For businesses, informality includes operating outside of the tax, registration, and other legal and regulatory frameworks.

Workers and businesses operate in the informal economy for a variety of reasons. For some, informality is a fallback plan when they are unable to find employment or business opportunities in the formal economy due to high barriers to entry or a lack of human capital.⁶ For these workers, informality is a survival strategy and not a business tactic. Others voluntarily choose to exit the formal sector because informality may offer greater flexibility or independence.⁷ Sometimes, individuals and businesses find that the costs of conforming to the regulations and laws of the formal economy exceed the benefits.⁸ These businesses choose to remain informal because it gives them a competitive advantage. Other businesses simply are not familiar with the processes to formalize.

These different groups of workers and businesses can be characterized by their varying levels of sophistication, including:

- at the lower end, mostly self-employed people trading in basic commodities like food or providing basic transport or other basic services; this group is often most in need of basic social protection, and generally have few other economic opportunities. Enforcement-centric strategies are not ideal for this group.
- at the middle level, those engaged in more organized trade and small and simple manufacturing of basic goods for customers in the informal economy; this group may respond better to productivity-increasing strategies and informational resources.
- at the upper end, those engaged in small scale manufacturing with low levels of technology (these can be part of more elaborate supply chains in the formal economy). This group also responds more to productivity-increasing strategies, and is a more appropriate target for increased enforcement.

Informality exists across a broad range of sectors, including tourism, vending, agriculture, manufacturing and many different types of services. While the informal economy shares some fundamental characteristics, many of the specific characteristics and challenges are country-specific. It is not a singular entity, and policy solutions cannot necessarily be transposed from one nation to another.

⁶ See for example: de Soto 1989, Perry et al 2007

⁷ See for example: Blanchflower, Oswald, and Stutzer 2001

⁸ Kanbur, R. 2009. “Conceptualizing Informality: Regulation and Enforcement.” IZA Discussion Paper 4186, IZA-Institute of Labour Economics, Bonn, Germany.

The causes of informality

Informality is a complex challenge, with multiple drivers and variation based on national circumstances. In the academic literature, there are two main schools of thought about the causes of informality. The first considers that informality is a symptom of underdevelopment. Under this approach, the informal economy is the result of low productivity of workers and firms. This is due to structural factors, including lack of physical capital, low educational level, and certain sociodemographic factors (such as a high incidence of young and rural populations). According to this perspective, policies to reduce informality should be aimed at increasing labour and business productivity.

The second school of thought considers that informality is the result of bad governance. Thus, informality is the response of the private sector to an overly regulated economy and an inefficient State. Under this approach, firms choose to operate within the informal sector when the costs of complying with regulations exceeds the benefits from accessing public services offered to formal companies. If informality is the result of poor governance, policies should focus on improving the regulatory environment and public services. Both schools of thought offer important insights. Informality is a complex and multifaceted phenomenon, not one that can be ascribed to a single cause.

Informality is deeply connected with the absence of economic growth, and especially productivity-driven growth. The differences between formal and informal firms are stark. One study found that the average informal firm from an emerging or developing economy is only one quarter as productive as the average formal sector firm.⁹ The reasons behind these differences are often poor policies or an inappropriate national legal and institutional framework that is not conducive to the development of formal businesses. Examples of these shortcomings include inadequate education and training policies, weak institutions, high transaction costs, overregulation, administrative systems that are prone to corruption and inefficiency, complicated and prohibitive taxation, the absence of property rights, a lack of access to credit and the absence of a facilitative and stable legal and judicial system.

Informality is not the result of globalization because the origins and main development of the informal economy pre-date the current phase of globalization. It is policy and institutional failures that continue to contribute to informality, thus resulting in the informal economy as a shelter for those who would otherwise have no employment, business opportunities or income sources.

Between formality and informality

Though policy discussions about formality often focus on the binary of ‘formal’ and ‘informal’, in reality many workers and businesses exist in a grey area between the two. This point has been highlighted often, for example in a United Nations report which notes that “economic relations—of production, distribution and employment—tend to fall at some point on a continuum between pure ‘formal’ relations (i.e., regulated and

⁹ <https://blogs.worldbank.org/developmenttalk/challenges-informality>

protected) at one pole and pure ‘informal’ relations (i.e., unregulated and unprotected) at the other, with many categories in between.”¹⁰

These many shades of grey – between formal and informal – have been widely documented. For example, in Peru, street vendors that exhibit some aspects of informality, such as not paying taxes nor complying with labour and health regulations, are regulated in other ways and often engage with state officials about these grey areas.¹¹ At the same time, much larger companies that can technically be ‘formal’ and exhibit many characteristics of formality can still engage in informal practices - for example by failing to comply with their full tax or social security obligations.

The international standards on informality

The challenge of informality has been clearly addressed in International Labour Standards, most recently and notably in ILO Recommendation 204: Transition from the Informal to the Formal Economy Recommendation, 2015 (R.204).¹² R.204 is wide-ranging, a direct consequence of the complex nature of informality. However, the recommendation lays out a number of important observations and principles about informality, including that Member States should:

- Assess the factors, characteristics, causes and circumstances of informality in their national context and design coherent and integrated strategies – including laws, regulations, policies, and other measures - to facilitate the transition from informality to formality.
- Formulate and implement a national employment policy, placing full, decent, productive and freely chosen employment at its centre.
- Take measures to achieve decent work and to advance the fundamental principles and rights at work in the informal economy.
- Progressively extend, in law and practice, social security, maternity protection, decent working conditions and a minimum wage to all workers in the informal economy.
- Take appropriate measures to address tax evasion and avoidance of social contributions, labour laws and regulations.

It also outlines the views of the ILO Member States on the nature and consequences of informality. Notably, it says that the informal economy is a “major challenge for the rights of workers, including the fundamental principles and rights at work, and for social protection, decent working conditions, inclusive development and the rule

¹⁰ <https://www.un.org/en/ecosoc/meetings/2006/forum/Statements/Chen%27s%20Paper.pdf>

¹¹ Roever, Sally C. 2005. “Negotiating Formality: Informal Sector, Market, and State in Peru.” PhD Diss., University of California, Berkeley, pg. 172

¹² http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO::P12100_ILO_CODE:R2

¹³ ILO R.204

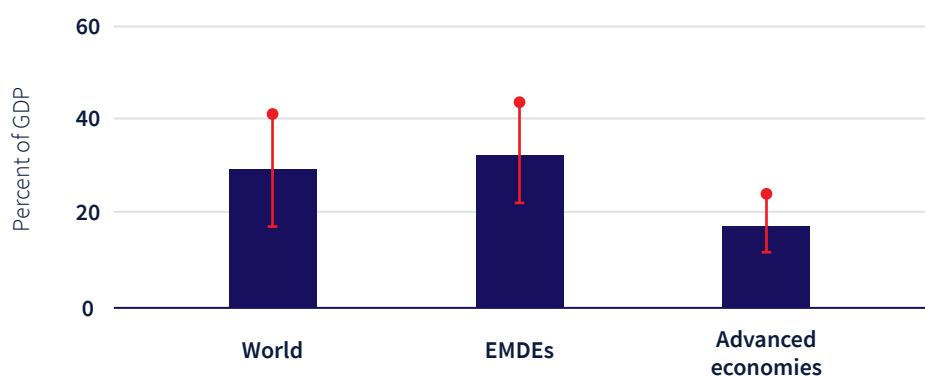
of law.”¹³ It goes on to note that informality also negatively affects the development of sustainable businesses, public revenues, the scope for government policy action, the quality of institutions and the fairness of competition. Echoing key findings in the literature, it also notes that most people enter the informal economy because of the lack of formal opportunities.

The conclusions also call for ILO Member States to take urgent and appropriate measures to enable the transition from the informal to the formal economy, recognizing both the large diversity of the informal economy and different national contexts.

3. How widespread is informality?

Though the size of the informal economy varies from country to country, it accounts for a significant share of both output and employment across almost all emerging markets and developing economies. Compiling reliable information on the informal activity is extremely difficult, in large part because of its very nature - operating outside of the law. However, various attempts have nonetheless been made to estimate the size of the informal economy. The World Bank has estimated that in emerging markets and developing economies, where the informal economy is more pervasive, it accounts for about one-third of output and more than two-thirds of employment. In EMDEs with the most pervasive informality, 46% of GDP was from the informal economy – twice the share of informal output in EMDEs with the least informality. In Sub-Saharan Africa, Europe and Central Asia, and Latin America and the Caribbean, the share of GDP from the informal economy averaged around 40% between 2010 and 2016.

Figure I: Informal Share of Output



<https://thedocs.worldbank.org/en/doc/37511318c092e6fd4ca3c60f0af0bea3-0350012021/related/Informal-economy-full-report.pdf>

The importance of the informal economy for employment is even more significant. The ILO has estimated that two billion people – more than 61% of the world’s employed population – make their living in the informal economy.¹⁴ However these people are not equally distributed around the world. Instead, they are heavily

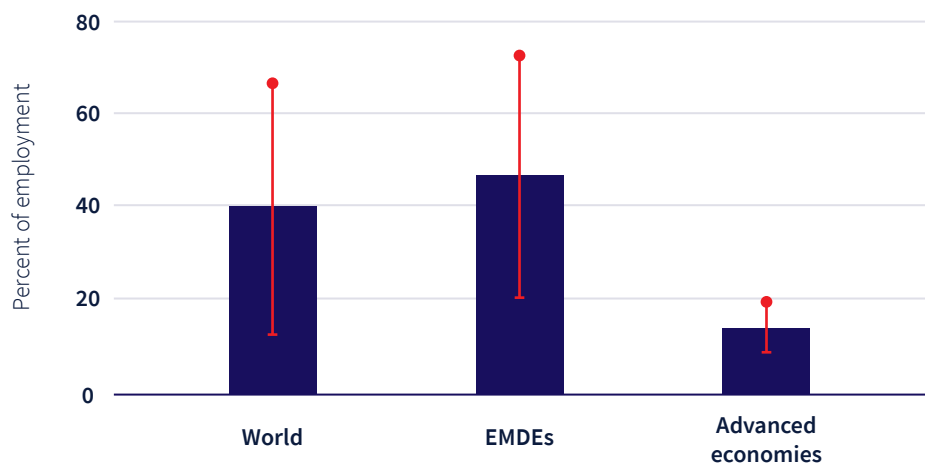
¹⁴ ILO, “Women and men in the informal economy: A statistical picture” April 2018

¹⁵ International Labour Organization (ILO), 2018, “Women and men in the informal economy: A statistical picture”

concentrated in the world's emerging and developing countries, which are home to the vast majority – 93% – of the world's informal employment.¹⁵

In many emerging markets and developing countries, the majority of the population works in the informal sector. The ILO and OECD found that the rate of informality in emerging countries is 67.4% and in developing countries, 89.8%, whereas in developed countries it is 18.3%.¹⁶ In Africa, 85.8% of employment is informal. The proportion is 68.2% in Asia and the Pacific, 68.6% in the Arab States, 40.0% in the Americas and 25.1% in Europe and Central Asia.¹⁷ The share of self-employment—another gauge of informality—in Sub-Saharan Africa, South Asia, and East Asia and the Pacific, ranged from 50% to more than 60% of total employment over the same period.

Figure II: Informal Share of Employment



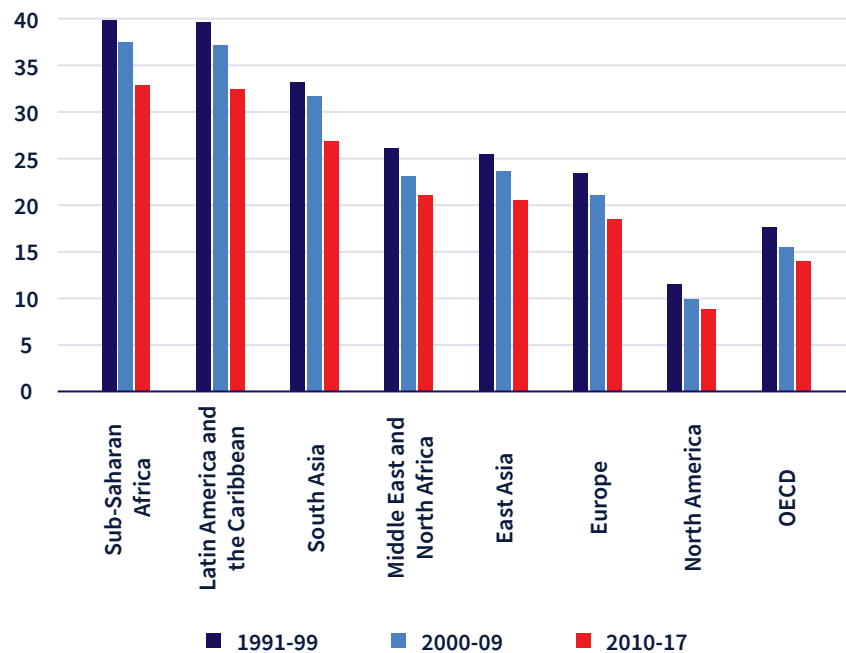
<https://thedocs.worldbank.org/en/doc/37511318c092e6fd4ca3c60f0af0bea3-0350012021/related/Informal-economy-full-report.pdf>

While the informal economy remains a vital source of economic output and work, over time its share of the world's total GDP has been declining. When measured as a share of GDP, the informal economy has shrunk gradually across all regions. This suggests that reforms to reduce informality, such as reducing the hurdles to registering a business, are gradually working, though also evidences how the shift from informal to formal takes time.

¹⁶ OECD-ILO, 2018, "Tackling Vulnerability in the Informal Economy"

¹⁷ International Labour Organization (ILO), 2018, "Women and men in the informal economy: A statistical picture"

Figure III: Informal Economy, average percent of GDP by region



Source: Medina, Leandro and Friedrich Schneider 2019. "Shedding Light on the Shadow Economy: A Global Database," IMF Working Paper

4. The consequences of informality

By its very nature, the informal economy is characterized by a number of negative attributes. It is associated with low productivity and poverty. Individuals and businesses in the informal economy have a more difficult time accessing capital, credit, technology, markets and institutions. For workers it can entail greater financial risk or fewer returns on their labour. It is connected to inferior working conditions, job insecurity, lack of access to state benefits and social security. For governments, it translates to lower revenues, affecting their capacity to build institutions and deliver services to the public.

The Effects of Informality on Women

Informal employment is vital for both women and men, but there are notable differences between genders. A higher share of men work in informal employment than do women – 63% to 58%. Out of the two billion workers in informal employment worldwide, just over 740 million are women.

However, women in informal employment, especially those from low and lower-middle income countries, are more often found in the most vulnerable situations.¹⁸ Though men were more likely to work in informal employment than women overall, in low-income countries this was reversed. There, 92% of women worked informally, compared to 87% of men.¹⁹ Women in informal employment were also much more likely to work as contributing family workers, who are often underpaid

¹⁸ International Labour Organization (ILO), 2018, "Women and men in the informal economy: A statistical picture"

¹⁹ ILO 2018

or not paid at all. More than 30% of women in informal employment in low and lower-middle income countries fall into this group.

The differences between woman and men working in informal employment also vary between regions. Women are more exposed to informal employment in 90% of sub-Saharan African countries, 89% of South Asian countries and almost 75% of Latin American countries. The highest gender gaps occur in the Gambia, Liberia, the Democratic Republic of Congo, and Zambia. Men are more likely to be in informal employment in North Africa, the Arab States and across Europe. In Iraq and Jordan, for example, the proportion of men in informal employment is 20 percentage points more than the proportion of women.²⁰

https://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/documents/publication/wcms_626831.pdf

One of the most significant consequences of informality is that it is closely associated with higher levels of poverty and economic inequality. Workers in countries with higher levels of informality were five times as likely to live in poverty than workers in countries with lower levels of informality.²¹ Similarly, levels of inequality were also higher in countries where informality was high.

The relationship between informality and poverty is in part because of the lower levels of productivity in the informal sector. The productivity gap between informal and formal firms is significant. In emerging markets and developing economies, this gap has been estimated as averaging 75%.²² This productivity gap also contributes to a wage penalty for workers in the informal sector. According to a review by the World Bank, the median wage of workers in the formal sector was 18% higher than that of workers in the informal sector.²³ Part of the reason for this gap in productivity and wages is the characteristics of workers in the formal and informal sectors. Workers in the informal sector tend to be “less-skilled, younger or older, and more agricultural than workers in the formal sector.”²⁴

Workers in the informal sector also face greater risks, including financial and health and safety risks. Many workers in the informal sector work on their own account, so do not receive a guaranteed salary. These workers are especially vulnerable to changes in their income. Workers in the informal sector are also regularly exposed to occupational hazards and diseases, yet lack either a formal employer who is responsible for their health and safety or access to a state-run social safety net.

Informality also has significant implications for the fiscal situation for governments. Generally, informal workers and businesses tend not to pay taxes and social contributions. Because of this, governments in countries with larger informal

²⁰ OECD-ILO, 2018, “Tackling Vulnerability in the Informal Economy”

²¹ World Bank 152

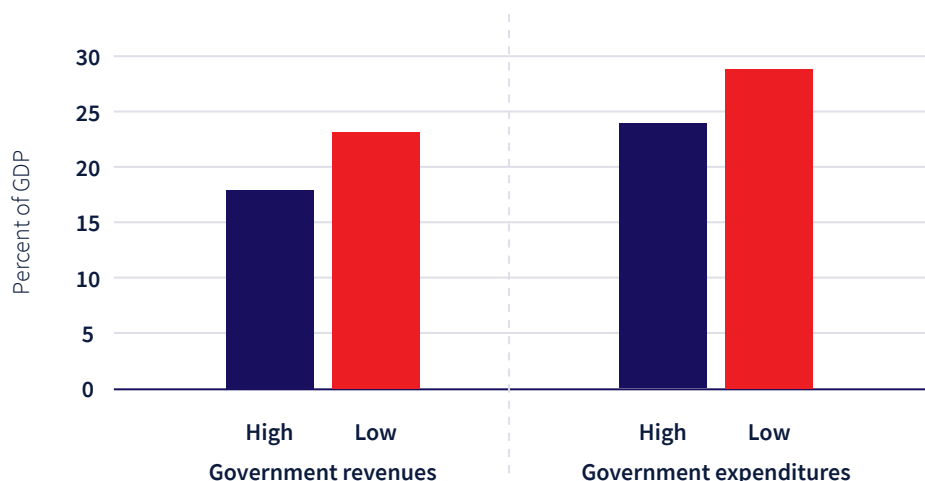
²² World Bank

²³ <https://thedocs.worldbank.org/en/doc/37511318c092e6fd4ca3c60f0af0bea3-0350012021/related/Informal-economy-full-report.pdf>, pg. 130

²⁴ <https://thedocs.worldbank.org/en/doc/37511318c092e6fd4ca3c60f0af0bea3-0350012021/related/Informal-economy-full-report.pdf>, pg. 132

economies tend to collect less tax revenue. Notably, EMDEs where the GDP of the informal economy is high average between 5 and 10 percent less government revenue and expenditure than EMDEs where the informal economy is smaller.²⁵

Figure IV: Informality and fiscal indicators



Eigen et al. (forthcoming); World Bank (2019); IMF Government Financial Statistics

Governments in countries with larger informal economies have less money, tend to be less effective, and suffer from higher levels of corruption. This undermines the quality of public services. The lack of national financial resources acts as a major barrier to the extension of social protection and other systems which are vital to national development, such as education and health systems. This creates the risk of a self-reinforcing negative cycle which further complicates the government's efforts to raise revenue or encourage the formalization of economic activity.

The shortfall in taxes and contributions, which is sometimes very significant, places an unfair burden on those businesses which are registered and do fulfil their obligations in this respect. As informal operators and workers tend not to pay taxes and social contributions, they can be engaged in unfair competition with formal businesses. Indeed, a large segment of the informal economy can consist of medium-sized companies that manage to evade all or part of their regulatory and fiscal obligations, often through connections with government officials.

Despite these negative attributes, the informal economy plays an important economic role in many countries. Not only does it act as a vital 'lung' allowing those who are excluded from the formal economy to survive, but it is also the place that many potential entrepreneurs get their start. Workers in the informal economy regularly show real business acumen, creativity, dynamism and innovation. This entrepreneurial potential can flourish if supported by the right services and incentives, as well as effective strategies to remove barriers to formalization.

²⁵ World Bank 2019

Informality and de COVID 19 pandemic

The coronavirus (COVID-19) pandemic has taken a heavy toll on emerging market and developing economies (EMDEs) that have large informal sectors. One of the most significant challenges has been reaching the many informal workers and businesses that are not registered with the government and cannot access benefits. In response to the COVID-19 crisis, many countries extended health coverage and other social protection measures to uncovered groups, especially informal sector workers. These measures were especially important in countries that went into lockdowns, which caused many informal workers to lose some or all of their income for a time.

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https://www.ilo.org/wcmsp5/groups/public/---ed_protect/---soc_sec/documents/publication/wcms_754731.pdf

5. Key policies to address informality

The informal economy is shaped by a wide range of government policies, and addressing it requires broad consultation and an all-of-government effort across that same spectrum of policy issues. Governments must work not only to address the consequences of informality, such as poverty. They must also work to address the root causes of informality, removing barriers and creating incentives for formalization while also providing informal businesses with the help they need to transition from informal to formal.

One of the most important policy areas that drives informality is the business-enabling environment, and increased focus on improving that environment is essential to effectively tackle informality. This should especially focus on the quality and sustainability of regulations – as inappropriately designed regulations are a key cause of informality. This can be aided by a range of steps, including but not limited to improving the policymaking process; instituting impact assessments; strengthening the direct and regular participation of the business community in the making of laws; exposing drafters of legislation to international experiences and practices; and ensuring that proposed policies are reasonable given the implementation capacity of domestic institutions.

Changes in policies and the policymaking process should all be done with a strong focus on local context. Transplanting policy and regulatory approaches from one

country to another would be a wrong-headed approach. Instead, significant and rapid effort is needed to analyse the local characteristics of the informal economy and apply those findings to policy design and processes. Changes should also be cognizant of the challenges facing particular groups, including women. Frequently, however, the policymaking process does not adequately consider the needs of women entrepreneurs and workers, which risks further exacerbating gender-specific constraints. Policymakers need to be cognizant of this, particularly taking into account cultural considerations.

Policies and programs to address informality should always retain a practical focus and be subject to regular impact assessments. Approaches must be pragmatic, focus on actual improvements in an entrepreneur's dealings with public institutions or regulations. They must also work to minimize unintended side-effects, especially the destruction of existing informal employment that is not transitioning to the formal economy. Governments should explore imaginative ways of 'encouraging' formalization and applying the law. **Above all, they need to see the private sector and its organizations as key partners in the quest to address informality.**

Informality and the digital transformation

While the informal economy remains a constant in all countries, digital technologies are changing the ways that informality works. This presents both opportunities and challenges for businesses and individuals. It does the same for governments, who must ensure that their policy framework to address informality is dynamic, responding to new technologies and how they are changing the informal economy.

For businesses and workers in the informal economy, digital technologies can help them address one of their greatest challenges: increasing productivity. Through technologies, informal sellers can reach new markets by marketing their goods through digital platforms or messenger apps. Technology can help reduce searching costs for taxi drivers or casual labourers. It can also help workers and businesses easily access physical capital they need to improve their productivity. For example, Hello Tractor in Africa helps farmers hire tractors through their mobile phones, and users have reported a 200 % increase in yields.²⁶

One of the most important ways technology can improve productivity is through using digital finance. Workers and businesses can send and receive payments through phones instead of having to use banks – which are rare in some places, especially rural and low-income areas. This is especially important for individuals and businesses in the informal economy, who are much more likely to be financially excluded. Digitization offers an unprecedented opportunity to address eligibility and affordability barriers to formal financial inclusion faced by informal individuals and firms. In particular, digitization can (i) facilitate identity verification, (ii) promote digital payments and (iii) improve the information

²⁶ <https://www.brookings.edu/blog/africa-in-focus/2018/01/26/foresight-africa-viewpoint-why-technology-will-disrupt-and-transform-africas-agriculture-sector-in-a-good-way/>

environment. However, to fulfil its potential digital finance must also increase consumer protection and financial literacy.

Digital technologies also open up new work opportunities, for example by allowing workers in one country to work with businesses in another as either a gig worker, contract worker or remote employee, all without having to physically migrate. These new forms of work bring new challenges in terms of social protection. They raise new questions, such as what constitutes the workplace for remote workers. And they can create complications where the legal framework is not appropriate for new forms of digital work.

Governments face a particularly difficult task of trying to help informal businesses and workers take advantage of the benefits of digital technology, while protecting them from some of the potential negative side effects. They need to keep legal and regulatory frameworks updated to allow for new types of commerce and work, while ensuring that digital and analogue businesses compete on a level playing field. They also have opportunities to use technology to promote formalization, for example by adopting simple digital business registration or by working with platforms to extend social protections to informal workers. Though these new technologies present significant opportunities, many governments around the world will struggle to make the most of them.

Existing policy analysis tools for the informal economy

Because of its importance to governments around the world, a wide range of policy studies and analysis tools for addressing the informal economy have already been developed. Recommendations about addressing the informal economy are similarly common, though vary from country to country. At the global level, a recent World Bank study outlines four main policy approaches that should guide work on the informal economy:

- 1. Improvements along a continuum**
- 2. Governance and public-private collaboration on mutual reforms**
- 3. Skills and business services**
- 4. Informality and trade²⁷**

There are a number of tools that exist to help analyse the informal economy. Figure V presents one such tool, a matrix of degrees of informality and factors driving formality. This tool can help better understand the relationship between factors driving informal behaviour, while also helping to identify businesses that may be more willing or able to formalize.²⁸

²⁷ The World Bank, 2014, “Informal Economy and the World Bank”

²⁸ <https://blogs.worldbank.org/psd/out-shadows-unlocking-economic-potential-informal-businesses>

Figure V: Business Differentiation Matrix

		Degree(s) of Informality		
		Legal	Fiscal	Labor
Internal Factors of Formality	Business Characteristics (# of employees, bookkeeping, productivity, capital, etc.)			
	Entrepreneur Characteristics (age, skilled, educated, gender, etc.)			
	Business Purpose (subsistence, growth, etc.)			
External Factors of Formality	Market Conditions (access to credit, market linkages, infrastructure, etc.)			
	Costs of Doing Business & Institutional Conditions (High transaction costs, corruption, trust, public services, etc.)			
	Labor (skills, availability, wages, etc.)			
	Business Culture/Tradition (Tax morale, trust, consumer confidence, discriminatory practices)			
	Business Relationships (associations, clusters, etc.)			

Source: <https://blogs.worldbank.org/psd/out-shadows-unlocking-economic-potential-informal-businesses>

Recent literature and analysis, informed in part by the above matrix, suggests four approaches that governments could use to address informality:

- 1. Target clusters of firms instead of individual businesses, as this generates benefits including market linkages and productivity spillovers that help improve productivity and profitability, which are associated with increased formality.**
- 2. Target productivity improvements, not formalization, as this addresses underlying challenges and could incentivize eventual formalization.**
- 3. Grant informal businesses a temporary or simplified legal and taxation status, as a step towards full formalization. This would allow governments to collect data on businesses that exist in the grey area between formal and informal, creating opportunities for additional contact to further promote formalization.**
- 4. For marginal businesses, focus on short-term benefits of formalization, not the medium-to-long term benefits.²⁹**

An efficient regulatory environment

Excessive regulation and bureaucracy directly lead to informality. It creates a strong incentive for businesses to avoid formal state governance, given the challenges associated with excessive regulation and bureaucracy. Further, a heavily regulated environment – especially one with poorly designed regulations – is associated with more corrupt practices. More complex licensing arrangements, higher amounts of

²⁹ <https://blogs.worldbank.org/psd/out-shadows-unlocking-economic-potential-informal-businesses>

paperwork, and a greater number of government agencies involved in regulation all create additional opportunities for corrupt practices to proliferate.

In recent years, policymakers are increasingly focused on improving the enabling environment for businesses. A good enabling environment has many characteristics, some of which are measured in indexes such as the World Bank's Doing Business indicators. Businesses should be able to formalize easily, and not require 200 days or 19 different procedures to register a business. Contract enforcement should be straightforward and not involve multiple procedures – up to 70 different in some countries. Laws should require certain disclosures to protect equity investors. The cost to enforce a contract should not be prohibitive for small and micro businesses. It should be straightforward to register commercial property. If businesses become insolvent and enter bankruptcy, creditors should have adequate and realistic protection. The minimum capital required to start a business should be reasonable, or simply not required at all. Fees for utility connections and compliance with building regulations should likewise be moderate and affordable. Speedy, efficient and effective access to courts and other low level dispute resolution mechanisms (for instance in dispute resolution with a supplier) should be guaranteed. Taxation should be realistic – excessive fiscal demands are a key driver of informality.

A good regulatory environment for business does not mean no regulation – far from it. More regulation is required in some country or policy areas, for example property rights. Essentially, what is needed is 'smarter' regulation – laws and rules that have been tested, that are workable and applicable to that national or regional situation and, above all, are affordable, sustainable, and enforceable.

Simplified business registration & start-up procedures

One of the most important and tangible areas of reform is also a key measure of formality – business registration. Importantly, business registration reforms are often not very complicated, costly, or politically difficult, especially in comparison to reforms in other areas such as labour regulations. Notably, electronic registration is increasingly common, and is present in more than 80% of high-income countries, though in only 13% of low-income countries.³⁰

Reforms to business registration can include: creating a single, centrally-located access point for business registration; creating a single business registration form; using a single identification number; margining overlapping registration requirements; and allowing the single registration number to be used across all government offices, including tax administration, customs and statistical office. Policymakers should eliminate all non-value-added steps, which sometimes are only in place to generate additional fees. Forms should be simple, use plain language in order to make regulations clear, and easy to complete. Complex forms often lead to mistakes, which can result in applications being rejected. Additionally, efforts should be made to publicize changes to processes and eliminate 'perceptions of complexity'. Making such registration available online can also remove scope for duplication.

Depending on the country circumstances, countries should strongly consider adopting processes that make business registration automatic, and not subject to

³⁰ https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_policy/documents/publication/wcms_635996.pdf

approval. Direct court involvement in registration, which is common in a large number of countries and results in lengthy procedures, should be abolished. Countries should instead opt for an administrative registration process with dedicated administrative staff.

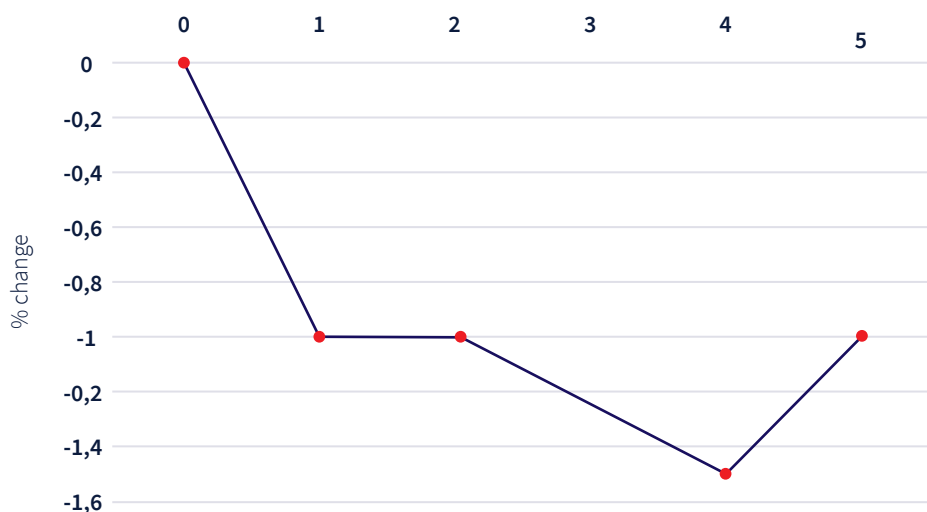
Some business start-ups may be more complex if they involve licenses and permits. Often these procedures require the coordination among various government agencies at different levels of government, often including regional or municipal authorities. The complexity of start-up procedures is often reflected in the documentation requirements, necessitating multiple visits to the same office. Eliminating duplication in licensing, or consolidating procedures, may help. Countries facing long delays could expand the “silence-is-consent” rule. This means that, if entrepreneurs have not heard from the government agency within a given number of days, approval is automatic, and they may start their business operations or continue with subsequent procedures.

Simplifying registration and business entry procedures is an important step to reduce the barriers for formalization. It is not, however, a cure-all. Businesses – both new and informal – look at the overall cost of regulation when deciding to register a company; and start-up procedures are only one part of the overall costs.

Flexible labour law

Many developing countries have extensive labour law protections which are designed to ensure workers are fairly rewarded for their labour. In reality, however, these protections often apply to only a small percentage of the private sector workforce, though often to larger groups of public sector workers. The vast majority of workers labour outside these formal protections in the informal sector. Yet increasing the flexibility of labour law is often politically fraught, and trade unions – who represent the small group of beneficiaries of this system – often oppose such changes. This is despite reforms that are often, contrary to popular perception, in the interests of workers as a whole. Yet governments face strong vested interests resisting reforms, making them challenging – as the recent example of Indonesia illustrates.

Figure VI: Decline in Informality after five years following de jure deregulation



Source: IMF 2019: Ch. 3, p. 109, World Economic Outlook, October

Reforms that bring about increased flexibility in the labour law framework often lead to a reduction in the share of people working in the informal economy. These reforms can be complemented by effective labour administration systems to maximize their impact. An effective labour administration system is an important part of a stable business climate. Legal compliance helps ensure a level playing field between formal and informal businesses, ensuring that the latter respect the same rules and standards. Proper labour inspection can help companies benchmark compliance and, rather than being purely a fine-imposing service, labour inspectors can help educate and assist business in meeting these obligations and moving toward formalization. Where informal economies operate it is important for government - with the support and engagement of the social partners - to extend its functions to these informal enterprises. This should be done in a way that encourages compliance. For this purpose, information and training are important tools for engagement. Over-reliance on fining non-compliant businesses, especially first time or minor offenders, will further exacerbate their reluctance to enter into the formal economy.

Robust social protection

To complement more flexible labour laws, a robust social protection system can protect workers between jobs while also providing coverage to workers in the informal sector. While social protection is a broad term, the ILO has stated that it includes “basic health care benefits, income security for children, elderly and disabled, and targeted income support for poor workers.”³¹ Social protection is an important right, and should be enjoyed by all workers in both the formal and informal economy.

Social protections schemes should be designed to have broad reach, covering as many workers as possible.³² In fact, social protection is especially important for workers in the informal economy, who are more likely to come from poor households and often exposed to occupational accidents, diseases and hazards. Because they work in the informal economy, OSH risks often go unnoticed by national authorities, and regularly involve hard-to-reach informal businesses.

Labour groups sometimes call for employers to bear the burden of social protection costs for their workers. For example, WEIGO argues that “social protection is a responsibility of those who benefit from the labour of workers and the goods and services produced by them.” They also note that “employers or owners of capital have a responsibility to provide social benefits for those who work for them.”³³ While these calls rightfully acknowledge the important role of employers, they must be complemented by efforts to cover the many workers who do not have employers. Similarly, some informal businesses with low levels of productivity may simply not be able to pay these costs, and may instead close or reduce their informal workforce. These marginal informal businesses are often not characterized by significant capital ownership – a key driver of their low productivity. Given these challenges, a robust social protection system must rely on more than employer contributions for its full funding.

³¹ https://ec.europa.eu/international-partnerships/system/files/informal-economy-and-decent-work_en.pdf

³² <https://www.wiego.org/social-protection-informal-workers>

³³ <https://www.wiego.org/social-protection-informal-workers>

Despite the costs, it is essential that employers support robust social protection, because they also benefit significantly from it. A robust system can make a flexible labour law framework more politically palatable. It can also play an important role in promoting access to health care and education, which directly contribute to enhanced nutrition and health, which are important ingredients for sustaining productive employment. Informality is often associated with lower education and health outcomes, and employers – even formal sector ones who use informal suppliers – stand to benefit from enhanced social protection.³⁴ Robust social protection also helps to build human capital, improve management of risks, promote investment and entrepreneurship and increase labour market participation – all of which benefit employers.³⁵

Access to credit

Workers and businesses in the informal economy have limited access to finance and, as a consequence, fewer opportunities to expand their business or respond to new opportunities. Lack of collateral is one challenge, freezing many informal operators out of formal credit institutions. Microfinance and micro-credit are important tools, and contribute to employment generation and wealth creation. They fill an important need, helping informal workers and businesses access affordable financial services that will allow them to make deposits, transfer funds, access insurance and invest in what they consider most important.

However, these institutions also face limitations, including on the amount of capital they can make available to one borrower as well as the types of financial products they offer. The lack of access to these services inhibits individuals from managing risk, and planning for the future and does not provide an important buffer for sudden emergencies, business risks and seasonal slumps. A range of policy tools can help informal businesses access credit, including associations of informal businesses or by state-backed loan underwriting.

Property rights

Security of tenure for property is vital for informal businesses, as it gives them confidence to invest, often in capital that enhances productivity. According to the World Bank, when property rights are not secure, fear of expropriation may drive entrepreneurs to make suboptimal investment decision.³⁶ However, when property rights are secure, it provides not only security but also collateral which businesses can use to access credit. Property rights empower informal workers and businesses and are a key ingredient in the move towards fully-fledged and growing enterprises.

Reforming systems of property rights can often require a broad long-term programme of reform, encompassing additional elements such as improvements in the land registry, collateral registry and access to the courts. Solutions need to be sustainable – the key objective is to enable assets to become and remain formal. If the formal cost of

³⁴ https://www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/---ilo-beijing/documents/publication/wcms_761053.pdf

³⁵ https://ec.europa.eu/international-partnerships/system/files/informal-economy-and-decent-work_en.pdf

³⁶ World Bank, 2020, “Doing Business 2020”

selling the property is high, titles will lapse into being traded informally.

Skills development and education

The inclusion of entrepreneurship, business and management skills in the public education curriculum is an essential element of a strategy to address informality. Arming young people with the knowledge and skills to establish and manage their own business gives them the tools to dream big and imagine that they can take control of their own economic futures. Education programs should emphasize the importance of formality – providing information about the processes and benefits of registering a business, securing financial assistance, and complying with regulations in areas like taxation and employment. These educational efforts should strive not only to encourage youth entrepreneurship, but also to create a culture of formality through the education system.

Informal workers, and potential future informal workers, have little access to education and training, in particular development of vocational skills. Building up this education system and improving access to it are vital steps to addressing informality. They should remain targeted at key groups, however. Workers in the informal sector are often less-skilled, younger, older and more likely to be in agriculture, so efforts to address human capital challenges could target these groups of workers given their high correlation with informality.

A focus on productivity

A key theme across all of the policy areas that can help address informality is a common theme: a focus on productivity. Productivity growth is vital to addressing informality, and many of these policies provide vital access to tools needed for informal businesses to improve productivity. Informal operators often have limited or no access to a whole range productivity-enhancing goods and services, including training, technology, support services, markets and investment capital, even in the form of small loans. The existence of the informal economy therefore tends to perpetuate low productivity and poor competitiveness in the national economy, both as a cause and a result of the poverty of informal operators.

Policies that improve skills and productivity therefore need to be addressed. Linkages between education and training institutions and informal enterprises can assist enterprises in productivity and skills improvements. Mechanisms can be put in place to identify informal businesses with the potential to supply goods or services to larger enterprises and then to facilitate contacts between such informal operators and larger companies.

6. EBMOs and informality: recommendations

Though employer and business membership organizations (EBMOs) are primarily representatives of mainstream formal economy enterprises, their role often directly intersects with the informal economy. This happens in areas where formal and

informal businesses share common interests – for example enabling-environment issues such as streamlining regulations or developing education and training systems. EBMOs also have a clear incentive to promote formalization, which contributes to a more level playing field between formal and informal businesses while spreading the tax and social protection burdens more evenly and equitably. They play a vital role in pressing for actions to help formalize the considerable employment and wealth creating potential of the informal economy.

The informal economy also presents an important opportunity for EBMOs to expand their service offerings, in ways that benefit both their existing members and informal businesses. They can offer services directly to informal businesses, such as providing access to information about registration, taxation, finance, insurance, technology and labour. They can also offer services targeted at informal businesses, including tools to improve productivity and develop entrepreneurial talent. They can implement activities targeting the informal economy in important areas including improving workplace safety and health and labour-management cooperation. They can also act as a conduit for the establishment of links between informal and formal enterprises.

For EBMOs, there are a number of benefits for expanding their work with and on the informal economy. They can enhance their standing as important national actors by constructively collaborating with other social partners to address the challenges associated with informality. They can introduce themselves to new potential members who are presently in the informal sector but may formalize in the future. They can create new revenue streams by providing services for informal businesses. This section provides a range of recommendations for EBMOs to help them to engage in effective advocacy and offer services to the informal economy.

Research and strategy on the informal economy

Before EBMOs roll out services, advocacy, and other support in their work on the informal economy, they may benefit from undertaking research and strategic planning to guide their engagement. The informal economy has unique local characteristics in all countries and understanding these is vital for EBMOs in fine-tuning their plans. A strategic review could help EBMOs better to clearly document their unique context and outline their future plans in a way that can be shared with all members and stakeholders. A strategic review could include the following topics:

- A contextual overview including macro-economic data on the size, sectoral distribution, and other characteristics of the informal economy. This section could also cover findings from surveys about the experiences of informal businesses or workers, or formal businesses that interact with them.³⁷
- Key policies which are shaping – either positively or negatively – the

³⁷ Household surveys often contain data on whether household members work in the formal or informal sector. Business surveys also regularly include questions on informality. The World Bank's Enterprise Surveys, which are done around the world, include questions about competition with and practices of informal competitors.

scale and nature of the informal economy, as well as any other non-policy barriers to formalization.

- Analysis of the competition between the formal and informal sectors.
- Key stakeholders that are either in the informal economy or interact with it.
- Areas of overlapping interest between existing formal EBMO members, the EBMO itself, and stakeholders in the informal economy.

EBMOs could also develop specific research products to help them address key challenges in their informal economy work. For example, they may develop case studies that document the business case for formalization. This could document the experience of a particular business, and show that while formalizing incurred some costs, it produced benefits that outweighed those costs.

In many of these endeavours, in order to maximize efforts, collaboration and partnership with other organizations representing business can be advisable. The ILO Bureau for Employers' Activities (ILO ACT/EMP) has developed a number of case studies of EBMO activities in tackling the informal economy.

Services for informal businesses

Businesses in the informal economy – much like those in the formal economy – often need services to help them start or grow. However, informal businesses often lack access to these services, constraining their development. EBMOs are often well-placed to deliver these services, as there are technical and administrative synergies with the services EBMOs offer to their formal sector members. EBMOs could offer a number of services to informal businesses, including:

- Advisory and information services about business registration, taxation, social security, labour compliance, finance, health and safety, and workplace relations.
- Training services specifically targeting informal or transitioning businesses, such as on financing, financial management, and human resources.
- Training and advisory services particularly targeting productivity growth. This could include productivity advisors or audits, coaching, and other services.

- Free or reduced-price trainings for informal businesses as part of their membership development strategy.
- A multi-faceted package of advisory and training services to help businesses transitioning from informal to formal. This single package could perhaps be introduced as a new type of membership at the EBMO and serve as an entry point for new members to join.

EBMOs could also consider applying for funding from public and private sector sources to offer a selection of services to informal businesses. These services should target particular areas where there is a clear public benefit – for example worker health and safety programs. They may also focus on areas where informal businesses would be otherwise unwilling to pay for training. Outside funding is most likely in these circumstances and could facilitate training that benefits multiple parties while also providing revenue and advertising for the EBMO.

Advocacy on the informal economy

Given the size and pervasiveness of the informal economy, it is essential that EBMOs have a well-developed advocacy strategy about informality. Some of that advocacy will be specifically focused on the causes and consequences of informality. However, given that informality connects with many existing policy questions, an EBMO's advocacy about the informal economy will likely cut across many existing advocacy areas. All advocacy on the informal economy should be cognizant of the multiple drivers of informality and avoid one-size-fits-all approaches.

EBMOs should have a number of overarching goals when engaging in advocacy about the informal economy and policy areas that directly connect to it. Some of the key goals include:

- Getting the government to explicitly integrate data and evidence about informality into policy-making across a wide range of areas, including but not limited to social protection, minimum wages, and working conditions.
- Adopting a realistic approach to informality that avoids putative measures for businesses that have no choice but informality, and instead focuses on providing assistance.
- Keeping a focus on incremental improvements.
- Ensuring that the costs of formalizing employment are not placed entirely on low-productivity informal businesses that cannot afford to comply with

these directives.

- Utilizing national processes such as the Poverty Reduction Strategy (PRS) processes in effecting policy and regulatory change.
- Ensuring that policies and programs on the informal economy do not discriminate but instead specifically target vulnerable groups including women, migrants, young workers, older workers, and those affected by HIV/AIDS.

EBMOs could develop and implement an advocacy agenda that addresses some of the most common enabling-environment challenges that are root causes of informality. Common areas for advocacy in many countries include:

- Business registration:
 - Reduction of existing registration processes
 - Introduction of a new, simplified registration process for informal microenterprises
 - Transparent registration processes conducted in an open atmosphere, for example a public website or a physically visible location with no back offices, limiting opportunities for corruption
 - Government assistance provided to businesses to register
- Taxation:
 - Streamlined tax regulations for informal businesses, including reducing the number of individual payments needed
 - Improved tax administration, including electronic tax filing and payments
 - Publicity campaigns to educate informal businesses about improvements in the taxation system
- Labour:
 - Increased labour market flexibility to encourage hiring
 - Ensuring that legally required labour costs are commensurate with levels of productivity
 - Improved social protection net to support workers, including those negatively affected by increased labour market flexibility

EBMOs could also consider advocating for governments to take other steps to reduce barriers to formalization and increase the incentives to do so. Potential steps include:

- Expanding e-government, including digital business registration, worker registration, tax filing and tax payments, in a mobile-compatible format. Governments should ensure these systems are compatible with digital accounting programs and digital platforms.
- Starting special financing programs that are:
 - Available to newly-registered businesses
 - Designated specifically to ICT investment, given that technology is associated with increased business productivity and formality.³⁸
- Reviewing and potentially reforming tariffs and taxes on machines and technologies that boost productivity.
- Advocating for improvements in other aspects of the enabling environment, for example improved regulations that promote access to finance or protect property rights, or the challenges associated with competition between formal enterprises and informal operators.

Support for informal sector institutions

While providing services to informal businesses and advocating for reforms to address informality are key steps for EBMOs, they can also play a role in supporting the development of organizations that work more closely with the informal economy. EBMOs could consider:

- Working directly with business associations whose members are predominately or entirely in the informal economy to deliver advisory and other services.
- Supporting the creation and development of member-based, accessible, transparent, accountable and democratically-managed representative organizations catering for informal economy operators.
- Assisting these organizations or other groups of businesses in developing a lobby agenda for small and micro enterprises.
- Acting as a conduit for establishing linkages between informal economy operations and mainstream formal economy enterprises.
- Undertaking initiatives to promote the formalization of informal economy operators in select sectors, as identified by existing EBMO members – a step that could also demonstrate the mutual interest in formalization shared by both mainstream formal economy and the informal economy operators.

³⁸ https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_policy/documents/publication/wcms_635996.pdf pg. 19



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