Informal sector support and Poverty Reduction

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February 2005

1 The following paper is a desk study of existing literature on behalf of the Swiss State Secretariat for Economic Affairs (seco).
Executive Summary

The recent trend towards democratisation and market-based systems has improved the live of millions worldwide. Many countries have increased political participation and achieved macroeconomic stabilisation and growth. However, there are also millions of people in emerging democracies who are excluded from the political and economic system and are living in poverty. A glaring symptom is the growing number of entrepreneurs engaged in low-income and low-growth business activities in the informal sector. Roughly a third of the GDP of emerging markets is produced informally.

This paper will provide a deeper insight into the relevant causes of informal sectors, the macro-level interventions needed to promote the formalisation of the informal economy, and the steps required to assist informal sector entrepreneurs within the informal sector.

High business costs and the informal economy are mainly caused by: ill-designed and unstable rules and regulations (particularly in relation to taxation, labour policy and business registration); a lack of well-defined and secure property rights; poor-quality or non-existent infrastructure and public services; deficient government capacity and resources to enforce laws and regulations; a lack of transparency, accountability and autonomy of governmental institutions (e.g. the judiciary); as well as a high degree of macroeconomic instability, unemployment and corruption.

The key to facilitating the informal sector’s participation in the formal economy, therefore, is to establish transparent and inclusive mechanisms through which citizens can regularly voice their concerns, participate in policy and law making, monitor public and private sector activity and hold public and private sector actors accountable. Further interventions include: fostering macroeconomic stability and growth; clarifying and streamlining legal and regulatory codes; ensuring and enforcing property rights and legal security; simplifying business permits and licences and making them affordable to all; reforming tax and labour policies; instituting corporate governance legislation, conflict of interest laws, international government procurement codes and anti-bribery principles; reforming bureaucratic government institutions and strengthening their administrative and enforcement capacities; making essential business-related information available to all; and providing high quality, cost-effective and well-maintained infrastructure and public services.

Some of the macro-level interventions aimed at formalising the informal economy also facilitate entrepreneurship in the informal sector and therefore are useful instruments for supporting actors within the informal sector, too. Examples are: efforts to promote macroeconomic stability and growth; to guarantee and enforce property rights and legal security; and to provide a minimal, but functioning and well-maintained, infrastructure.
Introduction

An extensive informal economy is characteristic of the business sector of many developing countries. Billions of dollars in potential profits are lost each year in emerging democracies and economies because ill-designed, complex laws and regulations exclude millions of citizens from the political and economic system and unnecessarily raise the costs of doing business in the formal sector. A recent IMF study revealed that about nine trillion dollars – roughly a third of the GDP of emerging markets – was produced informally. Similarly, ILO figures indicate that, in 1999, 17% to 84% of the urban labour force in developing countries worked informally.

The informal sector consists of entrepreneurs who produce legitimate products without proper permits and legal status because they lack the resources and/or the incentives to comply with the burdensome and excessive rules and regulations necessary to become part of the formal economy. Informal sector activities are extra-legal in the regulatory, but not in the criminal, sense. Hence, the informal sector is a very heterogeneous and complex phenomenon: it includes urban poor people, who depend on informal subsistence activities for their livelihood, as well as higher-income people entering the informal economy as a way of supplementing declining formal sector incomes or of increasing profit margins. The understanding of the complexity and heterogeneity of the informal sector has significant implications for any strategy and policy interventions trying to alleviate poverty in this sector and to formalise the informal economy.

A large informal sector has serious consequences for private sector activity, economic growth and the consolidation of democracy. It weakens democracy, hinders necessary reforms, and contributes to misguided policies due to the illegality of the ‘informals’ preventing them from voicing their concerns to government officials and holding them accountable. Therefore, reforms that would increase private sector activity and growth are not implemented. Because informal activities are not reported, policy makers do not have the necessary information to make adequate decisions.

Furthermore, if the legal and regulatory framework does not encourage an efficient use of resources, the economy cannot achieving its production potential. Resource allocation is distorted, while productivity and competitiveness are lowered, giving rich, but not necessarily efficient, producers an unfair advantage. The informal sector places significant constraints particularly on smaller firms, limiting their access to financial resources, public services and utilities, and narrowing the kind of contracts or investments they can make. Job creation and chances for upward social mobility are severely restrained.

Additionally, the failure to attract firms to formal market activities results in foregone tax revenues, which reduces government’s ability to finance essential business-related goods and services – and in turn discourages even more entrepreneurs from
paying taxes and business-related fees. High business costs and a lack of information and transparency also invite corruption. ‘Informals’ are illegal and therefore do not benefit from law enforcement services. They, therefore, have to resort to bribery in order to avoid costly punishment or to obtain certain services and protection. In short, high business costs and the informal sector are closely linked with low growth, poverty, reinforced inequality and the weakening of political and economic institutions.

What can be done to lower business costs? How can policymakers reform key political and economic institutions so that informal sector entrepreneurs in emerging democracies will participate actively in the formal economy and in policymaking? What can be done to assist people in the informal sector?

This paper will provide a deeper insight into the relevant causes of high business costs and informality, macro-level approaches and policy interventions to promote the formalisation of the informal economy, and action required to assist entrepreneurs within the informal sector. Poverty Reduction Strategies (PRS) should reflect these concerns, since they are supposed to enhance the interests of the people living in poverty, many of whom depend on the informal economy for their livelihoods.

1. Causes of high business costs and informal sectors

Where do high business costs and large informal sectors come from? Identifying the obstacles to joining the formal economy and the sources of high business costs is the first step towards reducing barriers to entering the formal economy.

The underlying reasons for many citizens in emerging democratic, market-based systems not participating in the political and economic system are the ill-designed ‘rules of the game’, undemocratic decision-making, and poor quality government services. These contribute to prohibitively expensive costs of doing business, the removal of incentives to comply with burdensome rules and regulations, and the erection of barriers to participation.

Among the most common examples of ill-designed rules and regulations are taxation and labour policies. High tax rates and poorly administered taxation systems reduce profit margins, which encourages tax evasion and recourse to the informal sector. Similarly, restrictive labour regulations impose substantial, fixed burdens on firms, particularly the low income-earning ones, and make the hiring of informal workers attractive.

Setting up a business is often a troublesome and long-term adventure. Acquiring legal property titles for assets such as a piece of land is one of the first steps to registering a business. The lack of well-defined and secure property rights lowers the incentive to register property and hinders the obtaining of credit and the conversion of
assets into productive capital. In his recent book, *The Mystery of Capital*, Hernando de Soto has argued that the developing world is sitting on some US$ 9.3 trillion in unreleased land value ('dead capital'), which is largely in the hands of poor people, because imperfect property rights do not allow their formalisation, capitalisation, and hence, conversion into working capital. De Soto illustrates how burdensome obtaining legal real estate titles can be in some countries: in the Philippines, for example, it requires 168 bureaucratic steps involving 53 public and private agencies and taking from 13 to 25 years. In Haiti it requires clearing 111 bureaucratic hurdles, and takes approximately 12 years.

Business registration requires more than 'mere' property titles in hand; entrepreneurs are confronted with further expensive and complicated licence and permit requirements. The Harvard Institute of Economic Research recently published a survey of the official requirements to set up a business in 75 countries. The results indicate that the process entails, at best, two steps, two business days, and US$ 280 in Canada; at worst, 20 steps, 82 days, and US$ 2996 in Bolivia.

Once registered, remaining formal is often made hazardous by unclear, unknown, conflicting, and frequently changing laws and regulations. In Peru, 73% of all costs of remaining formal came from following administrative rules. Complying with laws and regulations becomes even more overwhelming and costly if government agencies lack adequate financial, technical and human resources to administer and enforce them quickly and correctly.

The degree of transparency, accountability, and political autonomy of government institutions and the extent of officials' discretion in implementing and enforcing laws are other important factors influencing the costs of doing business. The judiciary is one of the most important government agencies in this regard: without an impartial, transparent, efficient and credible judicial system, business activity becomes very costly, thus encouraging recourse to the informal economy and weakening democracy and market-based transactions.

Poor-quality or non-existent infrastructure (roads, transport, access to public service utilities such as electricity, water, etc.) further raises business costs and hampers market efficiency by discouraging mobility, lowering productivity, stimulating corruption and further limiting access to markets. Moreover, entrepreneurs have little incentive to pay taxes or business-related fees for services that are poor or non-existent.

Finally, a high degree of macroeconomic instability (lack of fiscal discipline, highly volatile prices and inflation, high levels of government interventionism) also creates greater incentives to operate informally and induces capital flight, foreign exchange purchases and barter. Further high unemployment rates in the formal economy are reasons to turn to the informal sector. A recent poll in Brazil revealed that one third of
the respondents engaged in informal sector activities because of rising unemployment rates and lower wages in the formal economy.

In short, high business costs and the informal sector are mainly caused by ill-designed and unstable rules and regulations (particularly in relation to taxation, labour policy and business registration); the lack of well-defined and secure property rights; poor quality or non-existent public services; deficient capacities and resources of government agencies to administer and enforce laws and regulations; a lack of transparency, accountability and political autonomy of governmental institutions (particularly the judiciary); as well as high degrees of macroeconomic instability, unemployment and corruption.

A worldwide survey of 10,000 enterprises, carried out during 1999 and 2000 under the leadership of the World Bank, to document the leading obstacles to doing business identified by business managers and owners in developing countries confirms the relevance of the sources for high business costs and the informal sector mentioned above. The list is topped by: taxes and regulations, financing difficulties, inflation, and political instability or uncertainty. Among other obstacles perceived as very serious are: corruption, exchange rate problems and street crime.

2. Approaches to promote the formalisation of the informal economy

The main sources for high business costs and the informal sector presented in the previous section give a general overview of what is needed to reduce barriers to participation in the formal economy. Here, several intervention approaches aimed at opening up participation processes, stimulating informal sector formalisation and tapping its growth potential will be examined.

1. Fostering macroeconomic stability as a precondition for economic reform, growth and informal sector formalisation

A sound and stable economic foundation is a prerequisite for economic reform, growth and the success of subsequent measures. Governments should institute fiscal discipline and a monetary policy geared towards low inflation in order to attain and maintain macroeconomic stability. Also, the degree of intervention in the economy should be limited: more liberal trade regimes, exchange rate and interest rate policies and reduced barriers to foreign investment enable economic growth and create important enabling conditions for the informal sector to become formalised.

Interventions aimed at promoting broad-based growth and creating jobs in the formal economy generally improve the enabling conditions for a formalisation of the informal sector, unemployment in the formal sector being an important reason for becoming active in the informal sector.
2. **Increasing public participation and transparency in the policy making and legislative process by instituting transparent, inclusive decision-making procedures and providing regular opportunities for the public to comment on existing and proposed laws and regulations**

Countries with representative governments and checks and balances have significantly fewer entry barriers for new firms. In addition, checks and balances between government branches help minimise frequent, radical changes to the legal and regulatory framework. Hence, the business costs in the formal sector can be reduced through enhancing the degree of public participation in the policymaking and legislative processes by:

- instituting transparent and inclusive decision-making procedures;
- implementing legislative procedures that ensure public access to plenary and committee meetings;
- holding public hearings on proposed legislation and regulations;
- appointing independent ombudsmen to represent citizens' interests to legislators and government officials; and
- empowering citizens to initiate legislation and referendums and to challenge existing laws and policies.

Legislative advisory programmes, therefore, are an essential tool for reform, and policy dialogue is a valuable means of increasing its effectiveness.

3. **Clarifying and streamlining legal and regulatory codes by eliminating duplicative, superfluous laws that increase the costs of doing business and invite for corruption**

Laws and regulations should be clarified so that rights and responsibilities are clearly defined, rules clearly specified, and administrative and enforcement procedures simplified. Superfluous, complex and conflicting laws and regulations should be rescinded and the steps necessary to comply with laws should be streamlined in order to minimise the possibility of multiple interpretations and applications of laws and regulations. Any viable short-term strategy to improve the business climate and to reduce business costs should first of all ensure that the appropriate legal and regulatory codes are in place and regularly enforced.

4. **Making private property rights accessible to all, clearly defined and strongly enforced**
According to Hernando de Soto, prosperity cannot be broad-based until property rights are secure for all citizens. Property rights are the legal vehicle through which assets are converted into productive capital. They should, therefore, be reformed and strengthened so that private assets serve as an engine of growth and productivity. Property rights need to establish straightforward standards to identify asset owners and to indicate how property can be combined, leased, bought, sold or exchanged securely for productive purposes. Additionally, property rights, in order to be secure, need to be strongly and consistently enforced by an effective and impartial legal system.

A study by the World Bank and Princeton University showed that an initial investment of US$ 15 million in legalising dwellings and small enterprises in Perú, between 1990 and 1996, provided US$ 9.4 billion in additional income to poor people. Further, there was a 28% increase in school enrolment in shanty towns where legal security had been established.

5. *Simplifying business permits and licenses and making them affordable so that becoming part of the formal economy is within reach for entrepreneurs of modest means*

Business costs can be lowered significantly if processes to obtain business permits and licences are facilitated. Requirements to get a permit have to be simple, straightforward, well-publicised and accessible to entrepreneurs of modest means. A one-step process that can be followed in different cities throughout a country would greatly reduce start-up costs. Additionally, it should be legally mandated that, once these requirements are fulfilled, permits and licences are granted immediately and are automatically registered in a centralised business registry for public record.

6. *Reforming tax systems in order to encourage profitable economic activity and promote widespread compliance*

Taxation systems should be reformed by lowering the overall tax rate, by targeting corporate and income taxes, and by making tax codes simple and straightforward. Multi-step, complex procedures on fiscal reporting should be eliminated. Also, a consistent enforcement of taxation laws should be strengthened by increasing government’s administrative capacity and minimising officials’ discretionary powers.

Such measures not only lower business costs, they also tend to increase revenues by broadening the taxation base in the long-term. Higher revenues, in turn, prepare the ground for better quality public services – although one has to acknowledge that there is no automatic positive relationship between higher revenues and better public services.
7. Overhauling labour laws to allow for more flexibility

Labour, as well as tax policies, are key to improving the business environment. In order to make hiring of formal workers more attractive, labour regulations have to allow for more flexible work contracts, such as part-time or short-term employment or contract-based arrangements. Moreover, the right to associate freely should be vigorously protected. Individuals in any industry or sector should have the right to choose whether or not to join a trade or labour union.

8. Opening markets and combating cronyism through improved corporate governance legislation

Introducing corporate governance measures greatly helps to improve a country’s business climate. There is a need for legislation to protect investors, shareholders, and other stakeholders by adopting internationally accepted accounting principles, standards of disclosure, and anti-trust and anti-conflict of interest measures, as well as prohibiting insider trading and overhauling bankruptcy laws.

Clarifying conflict of interest laws, adopting Transparency International’s government procurement codes, and upholding OECD anti-bribery principles further help to combat cronyism and corruption: fewer funds will then line the pockets of government cronies and their private sector pals.

9. Reforming excessively bureaucratic government agencies and strengthening their administrative and enforcement capacities

Government agencies that are excessively bureaucratic and inefficient need to be reformed. This can be achieved by streamlining and simplifying agencies’ internal operating procedures and by regularly evaluating their performance according to clear and well-defined standards.

Furthermore, administrative and enforcement capacities of government agencies have to be strengthened. Successful means include: cultivating a staff of well-qualified civil servants, basing the hiring and promoting staff on verifiable professional standards, offering civil servants vocational training, paying adequate salaries to attract well-qualified personal and to deter bribe-taking, and offering tenure based on performance (not on the election cycle). In addition, sufficient financial and technical resources to administer laws expediently should be provided.

Particular emphasis should be given to reforming and strengthening the judiciary so that it enforces laws consistently, efficiently and fairly, thereby maintaining the rule of law.
10. Making essential business-related information available to all

Providing essential business information and training concerning how to obtain permits and licences, how to form legal commercial entities, how to invest, and how to understand and comply with business-related laws and regulations greatly increases transparency and facilitates complying with the requirements.

11. Providing high quality, efficient, and cost-effective infrastructure essential for a democratic, market-based system so that entrepreneurs benefit from joining the formal sector

The provision of a high quality, efficient, cost-effective and well-maintained infrastructure of transport, telecommunications, water, and power is essential for economic growth and the expansion of employment. Improved public services and infrastructure increase productivity, facilitate access to markets and, hence, provide an incentive for entrepreneurs to remain in, or to join, the formal sector economy. A fair amount of competition in these domains, through privatisation or transparent subcontracting bids with the government, greatly increases the efficiency, cost-effectiveness and quality of infrastructure provision.

The key to facilitating informal sector’s participation in the formal economy and in the policymaking and lawmaking processes is to institute democratic governance in the public and private sectors. This entails establishing mechanisms through which citizens can regularly voice their concerns and participate in policy and law making, monitor public and private sector activity and hold public and private sector actors accountable. Using such mechanisms, private sector associations and citizens can advocate for reforms that reduce business costs, and encourage and facilitate participation in the formal economy. Such measures help to make both the public and private sectors more responsive to citizen’s needs, increase efficiency, transparency, accountability and growth, and reduce corruption.

3. Approaches to support informal sector actors within the informal sector

Implementing only a few of the above-mentioned intervention approaches alone will not yet lead to a formalisation of the informal economy; the reasons for formal sector actors joining the informal sector are multi-faceted. However, some of the strategies that provide incentives for informal actors to join the formal sector also facilitate economic activity within the informal sector. This is particularly true for macro-level interventions aimed at creating a stable macroeconomic environment and promoting growth, ensuring property rights and legal security, and providing public services and infrastructure. Micro-level interventions providing Business Development Services,
micro-finance and skills training for informal sector actors or building capacities of grassroots self-help organisations will not be addressed further in this paper.

1. **Fostering macroeconomic stability and promoting growth as a precondition for any economic activity**

A sound and stable macroeconomic environment that enables economic growth, prevents high volatilities and dampens external and internal shocks not only stimulates the formalisation of the informal sector, but also facilitates business activity in both the formal and the informal sectors. The dynamics of a sound and stable economic environment, and increasing demands due to economic growth, will also positively affect informal sector activities. The same is true of a stable political environment and public safety, since high rates of crime and violence disproportionately affect informal sector actors such as street vendors.

2. **Ensuring private property rights for all citizens, clearly defined and strongly enforced**

Ensuring private property rights and legal security not only prepares the ground for formalising the informal sector. Secured, clearly defined and effectively enforced property rights greatly encourage any economic activity, also in the informal sector, and facilitate the conversion of private assets (dead capital) into productive capital. Without legally protected private property rights, entrepreneurs constantly face the risks of confiscation, forced relocation and harassment. In addition, they have few incentives to train personnel or purchase machines and other equipment in order to improve productivity and undertake larger-scale and longer-term investment.

Insecure property rights also damage economic performance in other ways: obtaining water, electricity and telephone services usually requires a property title. The same is true for access to finance and banking. In addition, as the World Bank and Princeton study showed, ensuring property rights and legal security for poor people also had a positive impact on school enrolment rates, thereby promoting human capital-building and skills acquisition.

Informal sector activities can also be supported by authorities applying more realistic land-use standards, and providing public land for enterprises and markets.

3. **Providing a minimal and well-maintained infrastructure essential for conducting any economic activity**

The provision of a minimal, well-maintained infrastructure of transport, telecommunications, water and power is essential for economic growth and the expansion

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2 According to instruction by seco.
of employment in both the formal and informal sectors. Besides adopting more realistic land-use standards and providing public land for enterprises and markets, authorities could actively support the informal sector by developing a basic infrastructure for informal enterprises. The installation of electricity or water, for example, spurs productivity. The same is true of transportation: a lack of access to transport discourages mobility, limits access to markets and to inputs for production and, therefore, affects productivity and profit margins in a negative way.

In short, some of the measures for stimulating the informal sector’s formalisation, presented in Section 2, also facilitate business activities in the informal sector. This holds for interventions at the macro-level – e.g. promoting economic stability and growth, ensuring property rights and legal security, and providing a functioning basic infrastructure – as well as at the micro-level – e.g. providing Business Development Services, access to micro-finance and skills training programmes. The strengthening of self-help grassroots organisations and informal entrepreneurs’ associations both supports increasing public participation in the shaping of policy and lawmaking processes, which is the first step towards a formalisation of the informal sector, and provides an impetus for pursuing own interests and rights within the informal sector.

Conclusion

This paper has provided a deeper insight into the relevant causes of high business costs and the informal sector, into macro-level approaches and policy interventions to promote the formalisation of the informal economy, and into the action required to support informal sector entrepreneurs within the informal sector.

Identifying the sources of high business costs and the informal sector is a first step towards reducing the barriers to entering the formal sector, while also supporting informal entrepreneurs within the informal sector. High business costs and widespread informal sector activity are mainly caused by: ill-designed and unstable rules and regulations; a lack of well-defined and secure property rights; poor quality and non-existent infrastructure and public services; deficient capacities and resources of government agencies to administer and enforce laws and regulations; a lack of transparency, accountability and political autonomy of governmental institutions; as well as a high degree of macroeconomic instability, unemployment and corruption.

In this regard, concrete intervention to promote the formalisation of the informal sector should focus on: promoting macroeconomic stability and growth; clarifying and streamlining legal and regulatory codes; ensuring and enforcing property rights and legal security; simplifying business permits and licences and making them affordable for all; reforming tax and labour policies; instituting corporate governance legislation, conflict of interest laws, international government procurement codes and anti-bribery principles; reforming bureaucratic government institutions and strengthening their
administrative and enforcement capacities; making essential business-related information available to all; and providing high quality, cost-effective and well maintained infrastructure and public services.

Some of the macro-level interventions aimed at formalising the informal economy also facilitate entrepreneurship within the informal sector. Cases in point are efforts to promote macroeconomic stability and growth, to guarantee and enforce property rights and legal security, and to provide a minimal, but well-maintained infrastructure. Interventions at the micro-level, such as the provision of Business Development Services, access to micro-finance and skills training programmes, which dominate most of the donor efforts in relation to the informal sector, have not been explicitly discussed in this paper.

The key to facilitating the informal sector’s participation in the formal economy is to establish transparent and inclusive mechanisms through which citizens can regularly voice their concerns and participate in policy and lawmaking, monitor public and private sector activity and hold public and private sector actors accountable. Private sector associations and citizens can use such mechanisms to advocate for reforms that reduce business costs, and encourage and facilitate the formal sector. This results in an increase in efficiency, transparency, accountability and growth and a reduction of corruption. Moreover, greater citizens’ participation in the shaping of reform processes will create a sense of ownership, which is essential for the consolidation of any democratic and market-based reforms.


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