



Microfinance Institutions: Drivers for formalization of micro and small enterprise clients

Bernd Balkenhol, Geneva University;

K. Paul Thomas, ESAF

Séverine Deboos-David, International Labour Organization



Session structure

- Intro on the subject – Severine
- Group discussion
- Presentation on why access to finance can be a driver for formalization – Bernd
- Presentation on the role of MFI to promote formalization: ESAF experience – Paul
- Conclusion



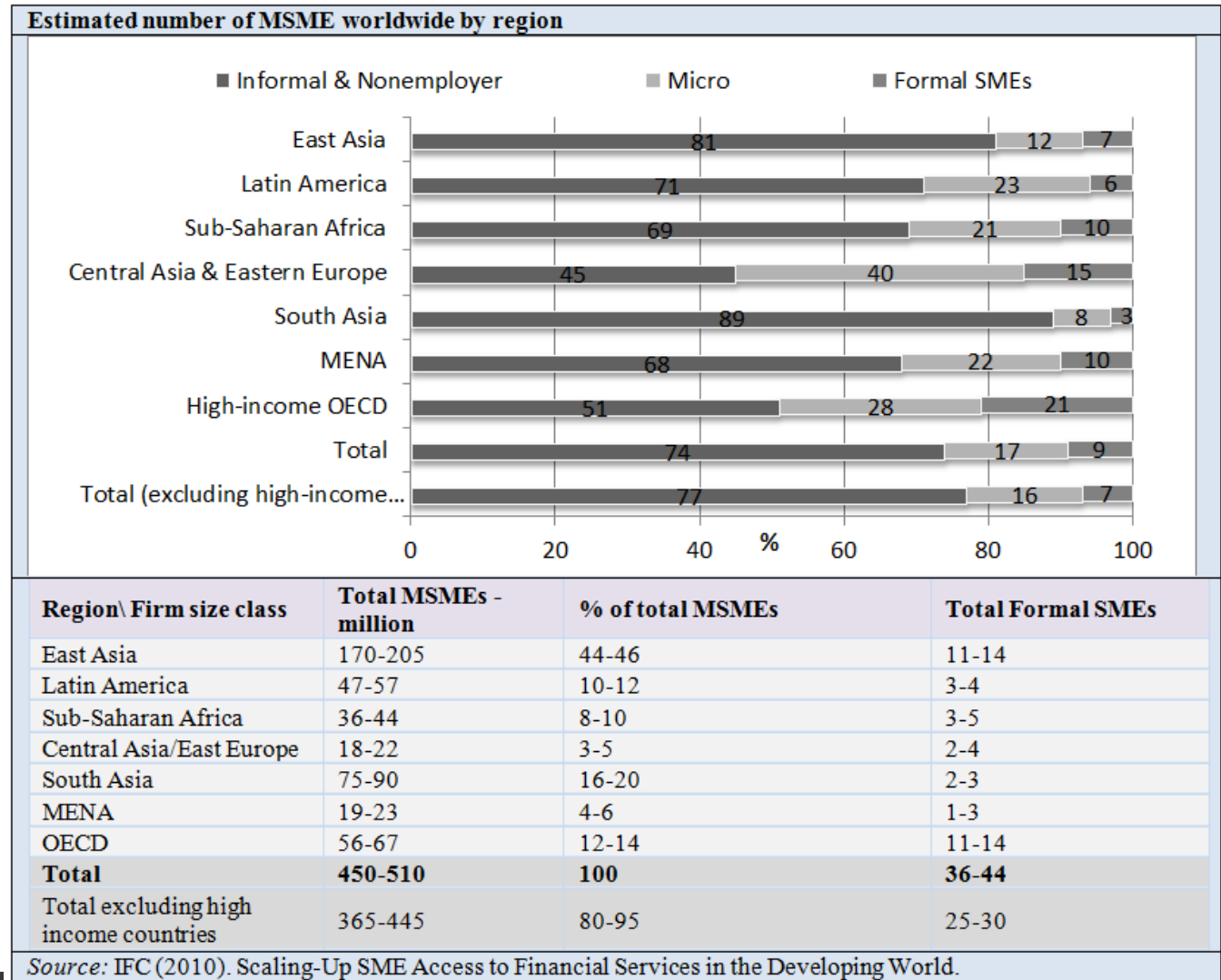
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Introduction

Key issues related to formalization of enterprises

How many enterprises are there in the informal economy?

- there are some 450-510 million MSMEs worldwide
- informal enterprises account for a large share of all MSMEs
- in developing countries informal SMEs outnumber formal firms of the same size
- in India in 2007 there were 17 unregistered SMEs for every



Are all informal enterprises the same?

Characteristic	Least dynamic		Highly dynamic	
	Completely informal		Partially formal	
	Informal economy			Formal economy
	Subsistence enterprises	Unofficial enterprises		
Mostly unregistered		Mostly registered	Official enterprises	
Owner profile	Poor, low education, low level of skills	Poor and non-poor, well educated, high level of skills registered	Non-poor, highly educated, sophisticated level of skills	
Finance needs	Working capital	Working capital, some investment capital, supplier credit	Investment capital and working capital, letters of credit, supplier credit	
Other needs	Personal insurance, social protection	Personal and perhaps business insurance	Personal and business insurance, business development services	

Why enterprise formalization?

The transition from a large informal economy to a large formal economy can have positive effects on various levels:

- **formal enterprises tend to perform better** than informal enterprises. At macro level, an increase in the number and/or size of formal enterprises translates into higher GDP levels and growth rates
- **many employees will benefit from such a transition**, because of higher labour productivity, higher wages and better working conditions are possible
- **higher revenues** in the country's tax revenues, which in turn can be used for various public programmes
- **improved general attitude towards government**: a transition from an informal to a formal economy could improve the general attitude towards government, which would in turn have a positive effect on the intention to comply with regulations

These factors have the potential to reinforce each other, e.g. a larger tax base allows higher government investments in infrastructure, education and the rule of law.

So why is formalisation so difficult then?

It seems that informal firms are making a rational choice on whether or not to formalize by comparing the expected benefits of becoming formal to the cost of doing so

- **costs:** Costs associated with becoming and remaining formal include entry costs (registration costs); taxes, fees and social contributions; and compliance costs (e.g. with labour regulations and property registration)

One cost that is real but is often forgotten is the cost of exiting the formal sector should it become necessary

- **benefits:** benefits associated with being formal include a reduction in the risk of closure or having to pay fines or bribes; that it is easier to establish an enterprise at a permanent location; that formal enterprises have better access to (public) business development services, financial services and insurance services; and getting access to more and different markets

One additional benefit is access to social protection for the entrepreneurs themselves and in some cases their families as well



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What is the underlying intervention logic?

Typically, policy interventions aimed at enterprise formalization focus on

- simplifying the process for registering informal firms (either registration of new firms or registrations of existing informal firms) and
- extending the benefits of formalization.

Key assumption: high cost of registering and running a formal firm, and missing or limited benefits derived from formalization, are the main reasons for informality.

Scarce preliminary evidence on the effectiveness of formalization measures show modest results, whether it is

- The effect of business entry reforms on firm registration
- The effect of business entry reforms on formalization of informal firms
- The effect of information, waived costs, and enforcement on formalization of informal firms

When looking at the benefits of formalization...

Access to finance: a key aspect

So...

Q1- Why MFIs should/could be interested in reaching out to informal enterprises???

Q2- What can be the role of MFIs to promote formalization?



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THANK YOU!