

# Institutional Reform and the Transition from Informality to Formal Enterprise Development

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## ABSTRACT

Informality remains one of the most persistent structural features of developing economies, with millions of enterprises operating outside the boundaries of formal regulatory and legal systems. This paper examines how institutional reform shapes the conditions under which informal enterprises make the transition toward formality. Drawing on institutional economics, particularly the frameworks developed by North (1990) and Williamson (2000), it argues that the decision to formalize is not simply a rational cost-benefit calculation. It is deeply embedded in the quality of a country's institutional environment. The paper reviews evidence on how regulatory burdens, property rights protection, and access to formal finance function together to either push enterprises toward formality or keep them locked in informality. It also examines how enforcement capacity and government credibility mediate reform outcomes. The paper concludes that sustainable formalization requires a coherent, sequenced institutional approach, rather than isolated deregulation or registration simplification.

**Keywords:** Informality, institutional reform, enterprise formalization, institutional economics, regulatory environment, developing economies

## INTRODUCTION

The informal economy is not a marginal phenomenon confined to the fringes of economic life. Across much of the developing world, it constitutes the primary mode of economic organization for millions of households and enterprises. According to the International Labour Organization (2018), more than 60% of the global workforce operates in informal employment, with the share rising well above 80% in parts of sub-Saharan Africa and South Asia. These are not idle workers or marginal operators. They are artisans, traders, transport providers, and service entrepreneurs who generate livelihoods and meet local demand, often in the complete absence of formal legal identity.

Yet their informality carries real costs. Informal enterprises typically cannot access formal credit, cannot enforce contracts through courts, cannot attract outside investment, and cannot scale in ways that would allow them to absorb more labor or improve productivity. The literature has long identified informality not merely as a symptom of poverty, but as a structural constraint that reinforces it (De Soto, 2000; La Porta & Shleifer, 2014).

The question, then, is not whether informality matters, but what moves enterprises from one side of the line to the other. This paper takes the position that the answer lies primarily in institutional reform. The rules of the game, as North (1990, p. 3) famously described institutions, determine whether formality is worth the cost. When those rules are poorly designed, weakly enforced, or actively exploitative, even enterprising and capable business owners have good reason to remain informal. When those rules are reformed to reduce costs, extend protections, and deliver reliable services, the calculus shifts.

This paper examines the relationship between institutional reform and enterprise formalization through several lenses. It begins by surveying the theoretical foundations from institutional economics, then turns to the empirical evidence on what drives informality and what reforms have shown results. It draws particular attention to the mechanisms through which reform operates, including regulatory simplification, property rights, access to credit, and enforcement capacity. It closes by drawing out the policy implications for governments and development institutions seeking to move enterprises into the formal economy.

## **THEORETICAL FRAMEWORK**

### **Institutional Economics and the Informal Sector**

The most influential theoretical lens for understanding informality in its relationship to institutions comes from the tradition of new institutional economics. North (1990) defined institutions as the humanly devised constraints that shape human interaction, encompassing both formal rules like laws and regulations and informal norms like social conventions and codes of conduct. His central insight was that institutions are not mere background conditions but the primary determinant of economic performance over time.

Applied to the informal economy, North's framework suggests that enterprises operate informally when the formal institutional environment fails to offer sufficient net benefits to justify the costs of compliance. Those costs are multidimensional. They include the direct financial costs of registration, licensing, and taxation, as well as the indirect costs of regulatory compliance, the time demands of bureaucratic interaction, and the exposure to corruption or arbitrary enforcement. When these costs exceed the benefits, which in weak institutional environments may be quite limited, enterprises rationally choose to remain outside the formal system.

Williamson (2000) extended this framework by disaggregating institutions across four levels, ranging from deep social norms and cultural embeddedness at one extreme to governance structures and resource allocation mechanisms at the other. His contribution was to emphasize that institutional change operates at different speeds across these levels, and that reform at one level may be undermined or constrained by inertia at another. This layered understanding is important because it cautions against expecting rapid formalization simply from changes in registration procedures or tax codes. Deeper norms around trust in government, perceptions of legal legitimacy, and informal social enforcement mechanisms may sustain informality even when formal rules improve.

Acemoglu et al. (2001) provided influential empirical grounding for the view that institutional quality, rather than geography or culture alone, explains long-run economic performance. Their demonstration that the type of colonial institutions imposed by European settlers had durable effects on present-day income levels supported the view that institutional structures are path-dependent and difficult to reverse. For the study of informality, this implies that countries with historically extractive or exclusionary institutions may face particular challenges in building the trust and administrative capacity needed to make formality attractive.

### **The Informality Decision as an Institutional Problem**

Earlier scholarship often framed the transition from informality to formality as a voluntary individual decision driven by cost-benefit calculations. De Soto (2000) was among the most influential voices in this tradition, arguing that informal entrepreneurs are, in effect, rational actors who choose informality because formal systems are inaccessible, costly, and unresponsive. His empirical investigations in Peru documented the extraordinary time and cost required to register a business legally, illustrating how prohibitive transaction costs could exclude even motivated entrepreneurs from the formal system.

La Porta and Shleifer (2014) offered a more differentiated picture. Based on survey data across multiple countries, they showed that informal firms are, on average, significantly less productive than formal firms. This finding cut against romantic views of informal entrepreneurship and suggested that informality is often associated with genuine capacity constraints rather than simply strategic choice. Their work pointed to a dual economy model in which the informal and formal sectors are not neatly integrated but rather separated by quality and capability gaps that make simple registration insufficient to drive real formalization.

Schneider and Enste (2000) contributed an important analysis of shadow economy size, causes, and consequences. They estimated that the shadow economy, broadly defined to include unreported income and unregistered economic activity, ranged from under 15% of GDP in high-income OECD countries to well over 40% in many transition and developing economies. Their analysis identified high tax burdens, excessive regulation, and weak institutional quality as the principal drivers of shadow economy size, consistent with the North-Williamson institutional framework.

Maloney (2004) challenged the purely involuntary view of informality, presenting evidence that many self-employed informal workers in Latin America had actively chosen informal status and perceived it as offering certain advantages, including autonomy and flexibility. This voluntarist perspective does not undermine the case for institutional reform, but it does complicate it. It suggests that reform strategies must make formality genuinely attractive, not simply compulsory, if they are to generate durable results.

## **THE NATURE AND DRIVERS OF INFORMALITY**

### **Defining Informality**

There is no single universally accepted definition of the informal economy. Hart (1973), who introduced the concept in its modern form through his study of urban employment in Ghana, used it to describe income-generating activities that operate outside formal wage employment structures. The ILO has subsequently defined informality in terms of the characteristics of employment and enterprise, including the absence of social protection, legal registration, and formal labor contracts. For this paper, informality refers primarily to enterprises that operate without formal registration and therefore without access to the rights and protections that formal legal status confers.

This enterprise-centered definition is consistent with much of the institutional economics literature and allows for a clear focus on the conditions under which transition to formality becomes feasible or desirable. It does not treat informal enterprises as inherently illegitimate. Many operate in ways that are entirely honest and socially productive. What distinguishes them is their relationship to the formal institutional system, a relationship shaped heavily by the quality of that system.

### **Regulatory Burden and Entry Costs**

One of the most consistently documented drivers of informality is the regulatory cost of entry and ongoing compliance. Djankov et al. (2002) provided a landmark cross-country analysis of the costs and procedures required to register a new business. Across 85 countries, they found enormous variation, with new businesses in some countries facing months of bureaucratic processing and costs amounting to multiples of average annual income. Critically, heavier regulation was associated not with better government performance but with greater corruption, larger informal economies, and weaker institutional quality generally.

The policy implication drawn from this evidence was that reducing entry costs, streamlining registration procedures, and eliminating unnecessary regulatory requirements would lower the barrier to formality. This logic informed the World Bank's Doing Business reforms, which encouraged governments

across the developing world to simplify business registration, reduce the number of procedures and days required, and lower associated fees. The World Bank (2020) documented substantial progress in many countries, with the global average number of procedures to start a business falling significantly over the preceding two decades.

Reducing registration costs alone, though, has not consistently produced formalization at scale. The gap between de jure regulatory reform and de facto institutional change has proven substantial in many contexts. Enterprises that have operated informally for years may not respond to easier registration if the broader environment of taxation, enforcement, and government service delivery has not also improved. As Perry et al. (2007) argued, formalization incentives must be coherent across multiple dimensions for reform to generate real behavioral change.

### **Property Rights and Contract Enforcement**

De Soto (2000) placed property rights at the center of his analysis of informality. His argument was that informal entrepreneurs often hold real assets, homes, land, and equipment, but hold them in legally ambiguous ways that prevent those assets from functioning as collateral or being deployed efficiently in formal markets. Without legal title, a house cannot secure a loan. Without a registered business, a contract cannot be enforced in court. The informal entrepreneur is thus locked out of the financial and legal infrastructure that makes capital productive.

This analysis generated enormous policy attention, and titling programs were implemented in several countries in Latin America and beyond. The evidence on outcomes has been mixed. Field et al. (2007, as cited in La Porta & Shleifer, 2014) found that titling in Peru increased labor supply and investment but did not consistently produce access to formal credit, in part because banking systems remained poorly adapted to serve small informal enterprises even when those enterprises held clear title. This suggests that property rights reform must be accompanied by financial sector reform if it is to translate into meaningful formalization.

Contract enforcement is similarly important. North (1990) emphasized that impersonal exchange, which requires trust in third-party enforcement, is what distinguishes modern market economies from those organized around personal relationships and repeated dealing. When courts are slow, corrupt, or inaccessible, enterprises face strong incentives to rely on informal social networks for contract enforcement rather than on legal mechanisms. Those networks function reasonably well within small community contexts, but they do not scale in ways that support growth. Institutional reform that improves judicial quality and access is therefore a precondition for the kind of trust in formal institutions that makes formalization worthwhile.

### **Access to Finance**

Informal enterprises are largely excluded from formal financial systems. Without registration, they typically cannot open business bank accounts, access commercial credit, or attract equity investment. This exclusion constrains growth directly and also represents a cost of informality that is often underweighted in simple entry-cost calculations.

The relationship between financial access and formalization runs in both directions. Enterprises that register gain access to formal finance, but enterprises that cannot yet access finance may have limited incentive to bear the costs of registration. Institutional reforms that improve financial inclusion, including through mobile banking platforms, micro-finance institutions with simplified documentation requirements, and credit guarantee schemes, can shift this calculus by making the financial benefits of formality more immediate and tangible.

The evidence from microfinance programs is instructive here. While microfinance has demonstrated the capacity to reach informal borrowers, the terms and scale of such lending often remain insufficient to support meaningful enterprise growth. Schneider and Enste (2000) noted that sustainable enterprise development requires access to longer-term investment finance, not simply working capital loans. This suggests that financial sector reform must address the full spectrum of enterprise financing needs, not only the entry-level products associated with microfinance.

## **INSTITUTIONAL REFORM AS A PATHWAY TO FORMALIZATION**

### **Regulatory Simplification**

The most straightforward channel through which institutional reform can encourage formalization is regulatory simplification. When registration is quick, cheap, and straightforward, the direct costs of entering the formal economy fall. Djankov et al. (2002) demonstrated that simpler entry regulation is associated with more productive, less corrupt formal sectors. The Doing Business index created by the World Bank operationalized this logic into a benchmarking tool that allowed governments to track progress on entry conditions and other aspects of the regulatory environment.

Countries that pursued sustained simplification programs often achieved measurable results. Rwanda is frequently cited as a case where wide-ranging administrative reform dramatically reduced registration times and costs, contributing to a marked increase in formal business registrations over a relatively short period. Mexico, Georgia, and several Eastern European countries similarly undertook reform programs that reduced regulatory burdens and were associated with increased formalization. That said, the causal relationship is difficult to isolate, since regulatory reform often occurs alongside other economic and institutional improvements.

Perry et al. (2007) cautioned that simplification alone is insufficient when the underlying reasons for informality lie beyond registration costs. If taxes are perceived as burdensome relative to the services they fund, if labor regulations impose high fixed costs on formal employment, or if enforcement is selective and arbitrary, even enterprises that have formally registered may revert to partial informality over time, complying with some obligations while evading others. True formalization, as opposed to mere registration, requires coherent reform across the full range of institutional interactions between enterprises and the state.

### **Tax Reform and Fiscal Incentives**

The tax dimension of informality is particularly complex. High tax rates and complex compliance requirements are consistently identified as drivers of informality, yet the revenue generated by effective tax systems funds the public services and infrastructure that make formality attractive. This creates a tension between revenue extraction and enterprise inclusion that institutional reform must manage carefully.

Simplified tax regimes for small enterprises, sometimes called presumptive or flat-rate tax systems, have been introduced in a number of countries as a way of reducing compliance costs for enterprises making the transition from informality. These regimes typically replace multiple separate taxes with a single periodic payment calculated on a simple basis, such as estimated turnover or business location. They reduce the administrative burden of compliance while maintaining a formal relationship between the enterprise and the state.

The evidence on presumptive tax systems is generally positive, though not uniformly so. When such systems are set at levels that accurately reflect the tax capacity of small enterprises and are accompanied by tangible services, including access to business development support, registration benefits, and

simplified banking, they can generate meaningful increases in formal registration. When they are seen as arbitrary or punitive, they may generate a veneer of compliance without genuine integration into the formal economy.

### **Property Rights and Legal Identity**

As De Soto (2000) argued, legal identity is foundational to participation in the formal economy. An enterprise without formal registration lacks the legal standing to enter enforceable contracts, to access court systems, or to own property in its own name. These are not minor inconveniences. They represent structural exclusions from the institutions through which modern market economies operate.

Institutional reform in this domain involves not only simplifying registration but ensuring that legal identity confers real and accessible rights. A business registration certificate that allows the holder to open a bank account and sue in court is qualitatively different from one that exists on paper but generates no practical entitlements. Building the administrative and judicial capacity to make legal identity meaningful is a slower and more demanding task than simplifying the paperwork, and it requires sustained political commitment.

North (1990) argued that the development of reliable institutions for impersonal exchange was the key institutional innovation underlying the rise of the modern economy. Extending that capacity to small informal enterprises in developing economies is, in this sense, a fundamental part of the unfinished institutional development project. It requires not simply legal reforms but the building of administrative systems, judicial capacity, and social trust in the reliability of formal institutions.

### **Enforcement Capacity and Government Credibility**

Institutional reform is only as effective as the state's capacity to implement it consistently. Weak enforcement capacity means that even well-designed rules produce unpredictable outcomes in practice. Acemoglu et al. (2001) showed that institutional quality, including the reliability of enforcement, is a deep determinant of economic performance. Countries where enforcement is selective, subject to corruption, or simply absent face particular difficulties in converting formal legal structures into behavioral change.

Enforcement capacity matters in two ways for formalization. First, enterprises are less likely to formalize when they doubt that doing so will actually deliver the promised benefits. If courts are slow or corrupt, if tax authorities are arbitrary, or if business development services are unavailable or poor quality, then the formal registration of an enterprise may impose costs without generating corresponding returns. Second, the threat of enforcement against informal operation is also a factor in the formalization calculus. When enforcement of regulations against informal enterprises is absent or inconsistent, the opportunity cost of informality remains low.

The credibility of government commitments is itself an institutional resource that must be built over time. Williamson (2000) noted that institutional credibility is a function of repeated interactions and established track records. Governments that have historically used regulatory systems to extract rents rather than provide genuine services face a credibility deficit that no single reform can fully overcome. Rebuilding that credibility requires sustained policy consistency, transparent administration, and demonstrable delivery of services to those who enter the formal system.

## **BARRIERS TO FORMALIZATION**

### **Structural Constraints**

Beyond regulatory costs and institutional quality, formalization is also constrained by structural features of the economy and of individual enterprises. La Porta and Shleifer (2014) documented that informal firms

are systematically smaller, less capital-intensive, and less productive than formal firms. This productivity gap reflects not simply the effects of informality but, in many cases, the underlying capacity constraints of enterprise owners, including limited education, limited access to technology, and limited market connections.

For enterprises with very low productivity, formalization may impose costs that cannot be absorbed without genuine damage to viability. A street vendor or small-scale artisan operating at subsistence margins cannot readily afford the tax compliance costs, minimum wage obligations, and administrative burden that formal status requires. This is not an argument against formalization, but it is an argument that formalization programs must be calibrated to the actual capacity of the enterprises they target, and that they must be accompanied by complementary support for productivity improvement.

Perry et al. (2007) introduced the useful distinction between formalization as exit, in which enterprises voluntarily move into the formal sector because it offers superior opportunities, and formalization as exclusion, in which enterprises are forced into informality because they cannot meet the conditions for formal operation. Effective reform policy must address both patterns, reducing barriers for voluntary entry while also building the broader economic conditions that make the formal sector a genuinely productive place to operate.

### **Informational and Social Barriers**

Informational barriers also matter. Many informal enterprise owners lack accurate information about registration procedures, costs, and benefits. They may believe the process is more onerous or expensive than it actually is, or they may be unaware of the specific benefits that formal status confers. Information campaigns and business development services that make the costs and benefits of formality more transparent can reduce this kind of barrier.

Social norms also shape formalization decisions. In communities where informality is the norm and where formal engagement with government carries social stigma or practical risks, the pressure to remain informal can be substantial. Williamson (2000) noted that informal norms and conventions are the most resistant layer of institutional change, often persisting for generations after formal rules have changed. Formalization strategies that work only through formal legal channels may therefore be ineffective without complementary efforts to shift the social perceptions and community norms that sustain informality as a preferred mode of operation.

Trust in government is a particularly important social variable. Where informal enterprises have historically been subject to harassment, arbitrary enforcement, or extortion by government officials, the prospect of formal registration may be experienced as an increase in exposure to predation rather than an extension of protection. Building trust requires demonstrated change in government behavior over time. It is not achieved simply by legal reform or public communications campaigns.

### **POLICY IMPLICATIONS**

The evidence reviewed in this paper points toward several practical principles for reform programs aimed at supporting the transition from informality to formality.

First, reform must be coherent and sequenced. Isolated interventions, such as simplifying business registration without addressing tax complexity, or extending property rights without improving contract enforcement, are unlikely to generate sustained formalization. The institutional environment operates as a system, and enterprise decisions respond to the overall quality and reliability of that system, not merely to any single component.

Second, reform must be calibrated to enterprise capacity. Programs designed around the needs and constraints of medium-sized enterprises may be entirely inaccessible to micro-enterprises operating at the margins of survival. Graduated compliance regimes, simplified tax systems, and targeted business development support are tools that can make formality accessible and worthwhile for smaller and less productive enterprises.

Third, enforcement capacity must be built alongside regulatory reform. Rules that cannot be reliably enforced, whether against non-compliant formal enterprises or against informal ones that undercut their formal competitors, generate perverse incentives and undermine the credibility of the reform program as a whole.

Fourth, the social and informational dimensions of formalization must be addressed alongside the legal ones. Information campaigns, community-level business support services, and government outreach that demonstrates the tangible benefits of formality can shift both the information environment and the social norms that sustain informality.

Fifth, and most importantly, government credibility must be built and maintained. This means consistent policy, transparent administration, genuine delivery of promised services, and accountability for enforcement failures and misconduct. Without credibility, even technically well-designed reforms will not achieve their intended effects.

## **CONCLUSION**

Informality is not simply a failure of regulation or a product of poverty. It is, at its core, an institutional phenomenon, a rational response by enterprises to the incentive structures created by the quality of the institutions they face. Moving enterprises from informality to formality therefore requires institutional reform that genuinely changes the costs and benefits of formal operation, not merely the paperwork associated with registration.

The theoretical frameworks developed by North (1990) and Williamson (2000) provide a foundation for understanding why this is so. Institutions are not neutral backgrounds. They are the rules, enforcement mechanisms, and social norms that shape whether formality delivers on its promise of protection, access, and opportunity. Where those institutions are weak, corrupt, or exclusionary, formality will remain an unattractive proposition for most enterprises regardless of how much simplification is applied at the registration stage.

Empirical scholarship, from Djankov et al. (2002) on regulatory entry costs to La Porta and Shleifer (2014) on the productivity characteristics of informal firms, confirms that the institutional environment is the primary determinant of formalization rates and outcomes. It also confirms that the path to a more formalized economy requires coherent, sustained reform across multiple institutional domains: regulatory simplification, property rights, contract enforcement, financial inclusion, and tax design.

The good news embedded in this analysis is that institutional reform is achievable. Countries from Rwanda to Georgia to Mexico have demonstrated that determined, sustained institutional reform can shift the environment for enterprise formalization in meaningful ways. The less encouraging finding is that such reform is politically demanding, administratively complex, and slow to produce results. It requires governments to invest in enforcement capacity, accountability, and trust-building over periods longer than typical political cycles.

For researchers, these findings point toward an ongoing agenda that examines not only which formal institutional changes are associated with formalization, but how those changes interact with social norms, government credibility, and enterprise-level capacity constraints. The transition from informality to formal

enterprise development is ultimately a social and political process as much as a legal and administrative one, and scholarship that takes that complexity seriously will be most useful to the practitioners and policymakers working to advance it.

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