

Our latest impact note looks at the demand for, and consequences of, formalizing among informal firms in Sri Lanka.

Do informal firms want to formalize and does it help them if they do?

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Most firms in developing countries are informal. Does it make sense for them to formalize? Hernando de Soto has famously argued that informal firms would like to be formal, only that burdensome entry barriers prevent them. The result, spurred by the efforts of *Doing Business* and investment climate reform efforts has been efforts around the world to streamline the entry process.

However, a countervailing view of informality views informal firm owners as rationally weighing up the costs and benefits of formalizing, and rationally choosing only to become formal when they grow large enough to benefit from the formal institutions of society. In this view, smaller, less productive firms don't see any gain to formalizing, so choose not to.

An experiment in Sri Lanka

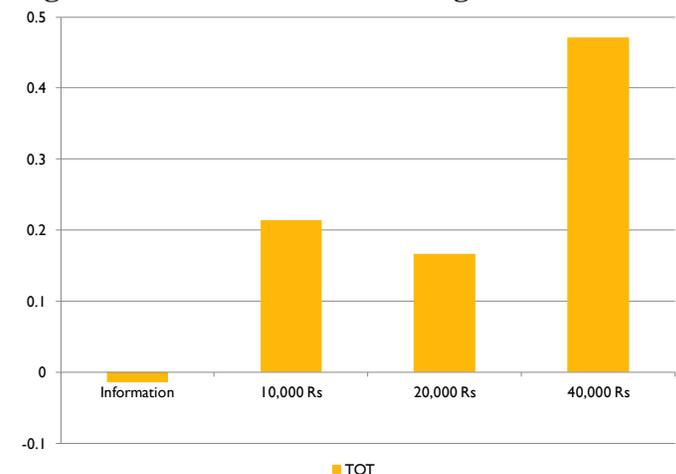
We conducted a field experiment in Sri Lanka which reduces the information costs and increases the monetary benefits of formalizing in order to measure the latent demand for formalization, and the consequences that formalizing has on informal firms. We divided a sample of informal firms with 1 to 14 paid employees into four treatment groups and a control group. The first treatment group was given information about the costs and benefits of, and procedures for, registering their firm for tax purposes, and offered reimbursement for the cost of registering. The second, third, and fourth treatment groups were provided the same information and also offered a payment of 10,000 Sri Lankan Rupees (LKR), 20,000 LKR and 40,000 LKR

(approximately US\$88, \$175 and \$350 respectively) to register.

Results

Figure 1 shows the impact on the likelihood of a firm registering. Information and paying the registration cost had no impact on registration. 17-22 percent of eligible firms register when offered 10,000 or 20,000 LKR, just under half a month's and one month's profits for the median firm respectively, and 48 percent register when offered 40,000 LKR.

Figure 1: Treatment effect on registration



The main reasons for not formalizing when offered incentives included issues related to ownership of land and concerns about facing labor taxes in the future. The degree of bureaucracy in the registration process also seems to matter for those with the incentive to register, with response to the incentives higher in Colombo, where the registration process was easier, than in Kandy.

What does formalizing do for firms?

We conducted three rounds of follow-up surveys at 15, 22 and 31 months after the start of the intervention in order to measure what impact, if any, formalizing was having on the firms.



Would formalizing help this firm?

We find:

- A positive mean effect on firm profits, which seems to be driven by the experience of just a few firms, which experienced large profit increases after formalizing; most firms saw no increase in profits (or sales or employment) after formalizing.
- Detailed case analysis reveals that these large changes in the tail were genuine, rather than measurement error.
- We find no significant effect of formalizing on relationships with the

financial sector – applying for business or personal loans or having a business bank account; or on relationships with the government – having an electricity connection in the business name, applying for a government contract, making sales to the government. participating in any government SME program.

- We do find formalizing causes firms to be more likely to use receipt books and to do more advertising.
- Firms which formalize also say they feel their businesses are more legitimate, and trust in local government increases.

Policy Implications

Our results suggest that most firms are rationally refraining from formalizing, since they see few benefits from doing so – while a few firms seem to be suboptimally informal. Nevertheless, our results do suggest that a relatively modest increase in the net benefits to firms of formalizing could dramatically increase the rate of formalization.

Moreover, our results cannot speak to whether simplifying registration has more benefits at the extensive margin (by encouraging more firms to enter), or has spillover benefits on other firms (by reducing a potential cost advantage informal firms may have against them). Measuring these types of impacts is a key area for future research.

For further reading see: Suresh de Mel, David McKenzie and Christopher Woodruff “The demand for, and consequences of, formalization among informal firms in Sri Lanka”, World Bank Policy Research [Working Paper no. 5991](#).

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