Formalization: Digitalization Can Empower But Not Replace a Better Business Environment

March 6, 2024
Norman Loayza, Director
Development Economics Global Indicators Group
Informality is Widespread in Developing Economies and One of Their Most Formidable Challenges

The chart shows the percentage of total employment in various regions as follows:

- Sub-Saharan Africa: 90%
- South Asia: 80%
- East Asia and Pacific: 60%
- Middle East and North Africa: 55%
- Latin America & the Caribbean: 40%
- Europe and Central Asia: 25%
- OECD: 10%

Developing Economies as a whole have an average of 60% of total employment in the informal sector.
The Substantial Economic Gains of Formalization

GDP per worker

Informal Employment: \( \frac{2}{3} \)
Formal Employment: \( \frac{1}{3} \)

GDP per worker \( \uparrow \) 70%
The Main Conclusion on Addressing Informality:

- Make Formality Attractive

  - Reducing the costs of becoming and remaining formal
  - Improving the benefits of being formal
Digitalization Can Help Make Formality Attractive

1. Providing Information
2. Reducing Transaction Costs
3. Promoting Transparent and Fair Competition
4. Facilitating Enforcement on Both Formal and Informal Enterprises
But Digitalization is Effective only when the Business Environment is Favorable

Digitalization cannot operate miracles
But, if the regulatory framework is too heavy, firms will still not register.
(2) Taxation – Digital Portal

- E-Filing of Tax Returns
- Automatic Tax Calculations
- Digital Payment Options
- Access to Tax Records

But, if tax rates are too high and taxation is complicated, firms will try to avoid and evade paying taxes.
(3) Dispute Resolution – E-Courts

- E-Litigation (e.g., Virtual Court Sessions and Case Management)
- Digital Payments of Legal Fees and Court-Related Payments
- Online Filing of Legal Documents
- Electronic Notification for Legal Appearances or Document Requests

But, if the judicial system is arbitrary and unpredictable, firms will not use formal courts or out-of-court mechanisms.
What is Needed?

Comprehensive Business Environment Reforms...

- Rigid labor market
- Cumbersome entry and exit
- Inexistent or confusing land rights
- Excessive and complicated taxes
- Financial and credit constraints
What is Needed?

Comprehensive Business Environment Reforms...
with Digitalization as a Facilitator

- Rigid labor market
- Cumbersome entry and exit
- Inexistent or confusing land rights
- Excessive and complicated taxes
- Financial and credit constraints
Digitalization is Effective only when the Business Environment is... *Business Ready*

- Opening a business
  - Business Entry
  - Business Location
- Operating & expanding a business
  - Utility Services
  - Labor
  - Financial Services
  - International Trade
  - Taxation
  - Dispute Resolution
- Closing a business
  - Market Competition
  - Business Insolvency
Thank you!