Going Informal: Benefits and Costs

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Abstract: All types of informal activities have something in common: the entrepreneurs who pursue them believe the benefits of informality outweigh their costs. Some activities will always stay informal: illegal activities like drug trafficking are one example. No amount of improvement in the regulatory environment for doing business will change their status. Fortunately, such activities account for a small share of gross domestic product in the average economy. Many activities that now take place in the informal or semi-formal economy in transition countries will be legalized if entrepreneurs see the costs of informality rising and its benefits falling. In this paper, we develop a taxonomy of informal activity. We then discuss the perceived costs and benefits of informality from the point of view of entrepreneurs, and of the government. Finally, we suggest several policy reforms, based on the experience in other countries.

1. Intro

All informal activity has one common feature: the entrepreneurs who operate in the informal economy perceive the benefits of doing so to outweigh the costs of going formal. Recent studies have identified a number of reasons why some business activity may take place in the shadows. The most important determinants are the prevalence of burdensome and costly government regulations (Johnson, Kaufmann, and Shleifer, 1997; Johnson, Kaufmann, McMillan, and Woodruff, 2000) and the level and administrative complexity of taxation (Enste and Schneider, 2000).

Informality comes at a cost: the inability to use government and some private sector services available to firms that fully comply with regulations. In countries where such services, for example credit services by state-owned or private banks, infrastructure services, organization of trade fairs, training of employees and managers, etc, entrepreneurs may well choose to be formal, even if regulations are many and taxes are high. This explains why Belgium does not have a large informal sector even though the tax burden on corporations is among the highest in the world. In contrast, entrepreneurs in countries where the quality of public services to businesses is poor have a much easier choice. In the absence of discernible benefits of going formal, they prefer to save their time and money and stay informal.

Many transition economies have experienced surging share of business activity in the informal sector.[1] Some of this activity is illegal (criminal), for example arms trafficking. Such activity will not become formal, regardless of improvements in the business climate. Other activities, like mom-and-pop retail trade or small production units operate merely for the subsistence of their owners and do not generate enough revenue to make their inclusion in the tax base meaningful. However, there exists a considerable share of business activity that is semi-formal, e.g., the company is registered but most employees are not, and can become formal with

[1] See Anderson (1998) for a summary of the evidence.

appropriate policy changes. In this paper we cover only informal activity that takes place in urban areas. Informality in rural areas is not addressed, since it has a number of additional determinants, including the lack of labor mobility. Also, many rural activities do not use electricity, which is one of the main ways to measure informal output.

Table 1 presents the best available evidence on the size of the informal sector in transition economies. Informality is least prevalent in the Czech Republic and Slovakia, at less than 20% in terms of both GDP and employment shares. Azerbaijan and Georgia have the highest shares, with more than half of production and employment operating in the informal sector. Some fairly advanced reformers like Estonia and Lithuania still have more than a third of their economy being informal.

Table 1: Size of the Informal Economy in Transition
(As a Share of GDP (in 2001) and Employment (in 1999))

Country	Share of GDP	Share of Employment[1]
Armenia	45.3	40.3
Azerbaijan	60.1	50.7
Belarus	47.1	40.9
Bulgaria	36.4	30.4
Croatia	32.4	27.4
Czech Republic	18.4	12.6
Estonia	39.1	33.4
Georgia	66.1	53.2
Hungary	24.4	20.9
Kazakhstan	42.2	33.6
Kyrgyzstan	39.4	29.4
Latvia	39.6	29.6
Lithuania	29.4	20.3
Macedonia	45.1	35.1
Moldavia	44.1	35.1
Poland	27.4	20.9
Romania	33.4	24.3
Russia	45.1	40.9
Serbia[2]	34.5	34.6
Slovakia	18.3	16.3
Slovenia	26.7	21.6
Ukraine	51.2	41.2
Uzbekistan	33.4	33.2

1) Working age population between the ages of 16 and 65.
2) Source: Report on Hidden Economy by Ekonomski Institut, 1997
Source: Schneider (2002).

This paper discusses the policy changes that are necessary for companies to go formal. We prioritize these changes using a cost-benefit analysis of informality. Entrepreneurs make choices based on their perceptions of what services they are foregoing by being informal; and what they gain by avoiding various regulations and taxes. This trade-off can be influenced by increasing the benefits and reducing the costs of formal business activity. Both the government and firms stand to gain from moving to a new equilibrium of low level of informality.

2. Types of Informality

Informal businesses usually fall into three broad categories: underground enterprises, subsistence enterprises and unofficial enterprises. Underground enterprises comprise largely of criminal activity and are out of the scope and focus of this paper. Subsistence enterprises result from 'coping strategies' adopted by families to compensate for low wages of external shocks (unemployment etc). Unofficial enterprises generally result from the desire to escape or avoid administrative and/or financial burden of regulation (license and permit regimes, taxes, labor regulations, etc.)

Firms around the world lie on a spectrum of business activity, ranging from informal to formal. One crucial difference about informal sector enterprises in ECA compared to other parts of the world is the size of the businesses. In most parts of the world, certainly in OECD countries, informal sector enterprises are almost always small in terms of assets and employees, which allows them to remain relatively invisible to authorities. In the ECA region, however, unofficial enterprises can be medium or even large enterprises with sophisticated activities. This happens because an enterprise is able to keep activities 'blended' i.e. part formal and part informal or unofficial. (Kaufman and Kaliberda, 1996) A typology of the informal sector is presented in Table 2.

Businesses in the subsistence end of the informal sector spectrum hold little potential for "graduating" to the next levels. Business failure rates are high because of high localized competition and lack of information or access to other markets. Moreover, many of these enterprises are short-lived until the household finds other sources of income that enables it to recover or surpass its living standards.

Unofficial enterprises in the small and medium end of the informal sector whose owners and employees are highly educated and have sophisticated skills hold the greatest potential to 'breakthrough' to the formal sector. This sub-sector is where there is a great deal of mixed activity, enterprises that may be formally registered, but some of their activities or employees are not officially reported. Improvements to the business and regulatory environment will provide incentives for these potentially dynamic enterprises to go formal.

Table 2. Typology of informal sector enterprises

	INFORMAL SECTOR			FORMAL
	Subsistence enterprises	**Unofficial enterprises**	**Unofficial Enterprises**	**Official enterprises**
Degree of Informality	100%	High. Proportion of sales undeclared and workers not registered	Some proportion of sales undeclared and workers unregistered. May use outside the official purview (eg internet to deliver software)	
Type of activity	single street traders, cottage/micro enterprises, subsistence farmers	small manufacturers, service providers, distributors, contractors	small and medium manufacturers, service providers, software firms	
Technology	labor intensive	mostly labor intensive	Knowledge and capital intensive	
Owner profile	Poor, low education, low level of skills	Poor and non-poor, well educated, high level of skills	Non-poor, highly educated, sophisticated level of skills	
Markets	Low barriers to entry, highly competitive, high product homogeneity	Low barriers to entry, highly competitive, some product differentiation	Significant barriers to entry, established market/product niche	
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	
	Least dynamic Completely informal		**Highly dynamic Partially formal**	

3. The Benefits and Costs of Informality for Entrepreneurs

Benefits

The main benefit from staying informal is the avoidance of (some) taxes and burdensome government regulations. Regulations impose both a direct cost in terms of fees or bribes to officials, and indirect costs measured in the entrepreneur's time spent on fulfilling various requirements and submitting documents. These cost differ enormously across countries. One example of regulations is business registration. In previous work (Djankov et al., 2002), we record the procedures related to obtaining all the necessary permits and licenses, and completing all the required inscriptions, verifications and notifications for the company to be legally in operation. When there are multiple ways to begin operating legally, we choose the fastest in terms of time. In some countries, entrepreneurs may not bother to follow official procedures or bypass them by paying bribes or hiring the services of “facilitators”. An entrepreneur in Georgia can start up a company after going through 13 procedures in 69 business days and paying $375 in fees. Alternatively, he may hire a legal advisory firm that completes the start-up process for $610 in 3 business days. In the analysis, we use the first set of numbers. We do so because we are primarily interested in understanding the structure of official regulation.

Regulations of start-up companies vary across regions within a country, across industries, and across firm sizes. For concreteness, we focus on a “standardized” firm, which has the following characteristics: it performs general industrial or commercial activities, it operates in the largest city (by population), it is exempt from industry-specific requirements (including environmental ones), it does not participate in foreign trade and does not trade in goods that are subject to excise taxes (e.g., liquor, tobacco, gas), it is a domestically-owned limited liability company, its capital is subscribed in cash (not in-kind contributions) and is the higher of (i) 10 times GNP per capita in 2001 or (ii) the minimum capital requirement for the particular type of business entity, it rents (*i.e.*, does not own) land and business premises, it has between 5 and 50 employees one month after the commencement of operations all of whom are nationals, it has turnover of up to 10 times its start-up capital, and it does not qualify for investment incentives. Although different legal forms are used in different countries to set up the simplest firm, to make comparisons we need to look at the same form.

Our data almost surely underestimate the cost and complexity of entry. Start-up procedures in the provinces are often slower than in the capital. Industry-specific requirements add procedures. Foreign ownership frequently involves additional verifications and procedures. Contributions in kind often require assessment of value, a complex procedure that depends on the quality of property registries. Finally, purchasing land can be quite difficult and even impossible in some of the countries of the sample (for example, in Croatia).

We use three measures of entry regulation: the number of procedures that firms must go through, the official time required to complete the process, and its official cost. We keep track of all the procedures required by law to start a business. A separate activity in the start-up process is a "procedure" only if it requires the entrepreneur to interact with outside entities: state and local government offices, lawyers, auditors, company seal manufacturers, notaries, etc. For example, all limited liability companies need to hold an inaugural meeting of shareholders to formally adopt the Company Articles and Bylaws. Since this activity involves only the entrepreneurs, we do not count it as a procedure. Similarly, most companies hire a lawyer to draft their Articles of Association. However, we do not count that as a procedure unless the law requires that a lawyer be involved. In the same vein, we ignore procedures that the entrepreneur can avoid altogether (*e.g.*, reserving exclusive rights over a proposed company name until registration is completed) or that can be performed after business commences. Finally, when obtaining a document requires several separate procedures involving different officials, we count each as a procedure. For example, a Bulgarian entrepreneur receives her registration certificate from the Company Registry in Sofia, and then has to pay the associated fee at an officially designated bank. Even though both activities are related to "obtaining the registration certificate," they count as two separate procedures in the data.

To measure time, we collect information on the sequence in which procedures are to be completed and rely on official figures as to how many business days it takes to complete each procedure. We ignore the time spent to gather information, and assume that all procedures are known from the very beginning. We also assume that procedures are taken simultaneously whenever possible, for maximum efficiency. Since entrepreneurs may have trouble visiting several different institutions within the same day (especially if they come from out-of-town), we set the minimum time required to visit an institution to be one day.

We estimate the cost of entry regulation based on all identifiable official expenses: fees, costs of procedures and forms, photocopies, fiscal stamps, legal and notary charges, etc. All cost figures are official and do not include bribes, which can be significant. Setup fees often vary with the level of start-up capital. As indicated, we report the costs associated with starting to operate legally a firm with capital equivalent to the larger of (i) ten times per capita GNP in 2001 or (ii) the minimum capital requirement stipulated in the law.

Our basic cost estimates ignore the opportunity cost of the entrepreneur's time and the foregone profits associated with bureaucratic delay. To address this concern, we calculate a "full cost" measure, which adds up the official expenses and an estimate of the value of the entrepreneur's time, valuing his time at the country's per capita income per working day. We report this number below, and have replicated the analysis using it as a measure of cost. The results obtained using this cost measure are very similar to those using the raw data on time and cost, and hence are not presented.

The business registration procedures are divided by their function: screening (a residual category, which generally aims to keep out "unattractive" projects or entrepreneurs), health and safety, labor, taxes, and environment. The basic procedure in starting up a business, present everywhere, is registering with the Companies' Registry. This can take more than one procedure; sometimes there is a "preliminary license" and a "final" license. Combined with that procedure, or as a separate procedure, is the check for uniqueness of the proposed company name. Add-on procedures comprise the requirements to notarize the Company Deeds, to open a bank account and deposit of start-up capital, and to publish a notification of the company's establishment in an official or business paper. Additional screening procedures that include obtaining different certificates and filing with agencies other than the Registry may add up to 97 days in delays, as is the case in Madagascar. Another set of basic screening procedures, present in almost every country in the data set, covers certain mandatory municipal procedures, registrations with statistical offices and with Chambers of Commerce and Industry (or respective Ministries). In the Dominican Republic, these procedures take 7 procedures and 14 days. There is large cross-country variation in terms of the number, time, and cost of screening procedures as the Company Registry performs many of these tasks automatically in the most efficient countries but the entrepreneur does much of the leg work in the less efficient ones. Additional procedures appear in four areas: tax-related procedures, labor regulations, health and safety regulations, and environmental regulations.

The data show enormous variation in entry regulation across countries. The total number of procedures ranges from 2 in Australia to 20 in Belarus and the Dominican Republic and averages 10.32 for the whole sample. Very few entry regulations cover tax and labor issues.

Procedures involving environmental issues and safety and health matters are even more rare. Instead, much of what governments do to regulate entry falls into the category of screening procedures. The worldwide average number of such procedures facing a new entrant is 6.26.

Table 3: Number of Procedures, Time and Cost for Registering a New Business

(Time is presented in business days; cost as a share of GNP per person)

Country	Procedures	Time	Cost
Albania	11	55	64
Armenia	11	55	12
Azerbaijan	15	79	19
Belarus	20	105	16
Bosnia	12	54	54
Bulgaria	10	24	8
Croatia	13	39	17
Czech Republic	10	62	5
Georgia	12	48	39
Hungary	7	65	64
Kazakhstan	12	42	38
Kyrgyz Republic	9	22	14
Latvia	7	23	34
Lithuania	11	47	5
Moldova	11	31	32
Poland	11	58	23
Romania	11	133	30
Russia	18	48	6
Serbia&Montenegro	16	62	21
Slovakia	11	89	13
Slovenia	8	54	12
Ukraine	13	30	23
Uzbekistan	7	29	34

Source: World Bank (forthcoming).

Business registration is only one of the various regulations that companies need to comply with. Enterprise surveys indicate that it is seldom the most problematic one for businesses. Acquiring business licenses in specific industries, obtaining permissions to export, registering property as collateral are among the more burdensome processes that an entrepreneur needs to go through. In most countries around the world, the costs of these processes are so high that business can only operate informally.

Who gains from having high barriers to entry and operations imposed by various regulations? Economic theories of regulation differ in their predictions as to who gets the benefits. The public interest theory predicts that stricter regulation is associated with higher measured consumer welfare. In contrast, the public choice theory sees regulation as a tool to create rents for bureaucrats and/or incumbent firms. Stricter regulation should then be associated with higher corruption and less competition. We have addressed this question empirically in previous research and find that the countries with less limited, less democratic, and more interventionist governments regulate more heavily, even controlling for the level of economic development. This evidence is difficult to reconcile with public interest theories of regulation but supports the public choice approach that emphasizes rent extraction by politicians (McChesney 1987, Shleifer and Vishny 1993). Entry and operations of businesses are regulated more heavily by less democratic governments, and such regulation does not yield visible social benefits. The principal beneficiaries appear to be the politicians and bureaucrats themselves.

Costs

Informality comes at a cost. First and foremost, informal enterprises need to stay small lest they become the target of government inspectors. Such firms are much more vulnerable to harassment by bureaucrats and are willing to pay higher bribes so that inspectors can look away. Surveys done by the World Bank estimate that informal firms in transition economies pay around 20% of their revenues to government officials in the form of bribes. Put differently, there is an implicit tax of 20% of revenues for being informal.

As stated earlier, this tax is still smaller than the taxes the entrepreneur would have to pay if going formal. In addition to corporate income taxes, legitimate businesses also pay social security taxes, VAT or turnover taxes, public service taxes, insurance for employees, etc. Hence, many entrepreneurs put up with harassment and continue informal operations.

While the cost of informality in terms of implicit taxes is high, the main problem comes from the uncertainty in the prospects of the enterprise. Informal enterprises are highly vulnerable, and can be closed at the whim of bureaucrats once they have been "located." While a small business can in principle move and avoid excessive harassment, in practice people lack the resources to relocate. Also, often informal businesses depend on being known by word-of-mouth advertising. A move to new premises would disrupt the demand for their product.

In normal circumstance, a business would be able to file a complaint against a zealous inspector. Not so if the business is informal. The services of the courts or the police are only at the disposal of legally operating companies. In countries where the courts and the police are inefficient and corrupt anyway, there is really no recourse for entrepreneurs of any kind, formal or not. However, in countries with reasonably functioning law and justice systems, entrepreneurs have a lot to lose by operating informally. The obvious channels for enforcing contracts and defending their property rights against competitors and government bureaucrats are not available to them. This suggests that one of the most powerful ways, perhaps the most powerful, to reduce informality is to improve the functioning of law and justice.

Another consideration of being informal, and the one most relevant for employees in such enterprises, is the absence of a safety net. Employees are not covered by the insurance and pension systems that the government and/or formal enterprises offer. If the firm fails, so do the prospects of its employees. Household surveys indicate that employees are willing to forego a 40% cut in wages in order to move to formal enterprises. This shouldn't be surprising: in the average developing country social security benefit account for over half of official salaries.

The costs of informality also include the inability to tap formal credit channels and more generally the various types of SME assistance programs available to the private sector. Much of the literature on the development of small firms puts the lack of access to financing as the main problem for new enterprises. More recent work, e.g., Johnson, McMillan, and Woodruff (2002), disputes these results and ascertains that the enforcement of property rights, i.e., the institutions discussed in the previous paragraph, are most important. Whether it be the number one or two factor, access to financing is key for the growth of businesses.

Many governments have recognized this need and have provided, with mixed results at best, vehicles for financing new and small firms. In all cases, a requirement is for the firm to be registered and to show certified financial statements for a given number of years. This precludes access by informal firms.

Instead, as shown in a number of empirical studies, informal sector businesses rely largely on informal sources (personal savings, family or friends, moneylender, pawn shops, remittances from family members abroad) to obtain financial resources. While the existence and ease of access from these sources provide a good reason to stay informal, the costs of borrowing from some of these sources can be high enough to raise operating costs significantly and threaten a business' financial viability. For example, moneylenders interest rates in many transition countries range from 5-10% a month. Finance from friends and family is unreliable, untimely and can bear significant non-financial costs.

Informal sector entrepreneurs often need to build their own (as well as their employees') human capital as their businesses grow. 'Breakthrough' businesses that are poised to grow from small to medium and beyond are in need of services that can help upgrade the owners skills. These services include assistance with business planning, information about markets and resources, marketing strategies, and financial management. Yet these types of business development services are either prohibitively expensive or unavailable to informal sector businesses.

4. The Benefits and Costs of Informality for Governments

Governments often lament the increase in informal sector activity since it reduces the tax base. While true, this concern is exaggerated. Many of the businesses that operate informally, e.g., the mom-and-pop operations described earlier, would not be able to run officially since the additional costs outweigh profits. If forced into the formal economy, many firms will fold. Only through the introduction of a simpler tax regimes and less regulations will the tax base increase.

The real economic cost to governments is in the numerous programs that they implement to deal with poverty – from subsidized health care, to subsidized or free housing, large unemployment benefits, free training, etc. These programs target the very same strata of society that often operate in the informal economy and, for reasons already mentioned, are not adequately protected. Recent research, e.g., Glaeser and Gyourko (2002), suggests that governments may do well to shift their focus from subsidizing particular programs such as basic housing to creating an environment where businesses can grow and prosper.

The social cost can be large as well – people in the informal economy are the first to be hit by worsening economic conditions and also have little to lose from staging protests and demanding support by the government. History is replete with cases of governments that have failed to appreciate the dynamics of poverty. Many studies identify the poor as working in the informal economy. Perhaps the greatest contribution is this area is due to Hernando de Soto and his work on informality in Peru. The basic argument is that formal businesses depend on secure property rights which in turn stem from well-functioning institutions that define and enforce contracts. Entrepreneurs need the government to maintain such institutions, and would support any government that does so.

5. How to Go Formal?

Several changes need to take place in transition economies to improve the environment for operating a formal business. Here, we focus on four of them, although the reader can think of a number of additional areas where reform is necessary. The four areas we cover constitute, in our view, relatively painless reforms that would not meet strong political resistance and can be seen as win-win changes for government and business alike.

<u>Reducing the number of business licenses, permits, approvals</u>. There are many good reasons why governments regulate business activity. Those relate to ensuring the health and safety of employees and consumers; clear environment; standardization of products; fair disclosure, etc. At the same time, many countries have a multitude of regulations that are archaic and do not serve a useful purpose anymore. Also, government agencies or institutions often manage to impose regulations that benefit themselves at the expense of businesses and the rest of the government: by collecting fees to supplement their budgets or by creating additional responsibilities for their staff and thereby maintaining or increasing employment. In such cases. Reviews and updates of existing regulations and a procedure for streamlining the regulatory burden are highly desirable but extraordinarily difficult. The most dramatic regulatory reviews were in leading transition countries (Czech Republic, Hungary, and Poland) undergoing fundamental transformation from central planning to market systems, and simultaneously integrating the 80,000 pages of the European *aquis communautaire* as part of EU accession. In Hungary, for example, 799 of the 983 existing laws were adopted after 1990. Substantial reviews of existing laws and other regulations have also been carried out in OECD countries, most notably Korea, Mexico, and Australia. Korea succeeded in eliminating 50% of its regulations in less than a year, while Mexico revised over 90% of its national legislation in about six years. Of these countries, though, only Australia designed and launched a national review of regulations without facing a substantial economic crisis.

Examples of successful multi-year generalized reviews can be found in Hungary, Australia, and Korea.[2] For lack of space, only the Hungarian experience is summarized here. The Hungarian government-wide regulatory review of 1995-1998 was co-ordinated by a central unit, the Government Commissioner, assisted by a small secretariat and advised by a Deregulation Council. The review was based on a three-year planned schedule of ministerial submissions and included subordinated regulations as well as laws. The revision was divided into two stages. The first 18 months concentrated on laws and regulations existing before 30 June 1990; the next 18

2 The section is based almost entirely on work by Scott Jacobs at the OECD.

months focused on the review of regulations enacted after that date. An important element of the programme was the preparation by the Ministry of Justice of a precise inventory of existing laws and regulations. Based on this inventory, the Government Commissioner and the horizontal ministries presented a detailed schedule covering the whole three years government's period. A submission process was designed which in theory included a RIA checklist. A special justification memorandum was requested for maintaining regulations enacted before 23 October 1989. The Government Commissioner could recommend that the government reject such regulations or could ask for further analysis. Last, the Ministry of Justice was charged with preparing a specific "deregulation instrument" to be issued by the government or presented to the Parliament listing unnecessary regulations abrogated.

In parallel to this item-by-item approach, the Hungarian government took a comprehensive approach to a few key policy areas vital to the proper functioning of democratic and market-oriented systems. For example, the civil code was reviewed in its entirety under the "deregulation of merit" process. Due to the size, complexity and impact of such codes or "codex", the revision was organized through working groups that work for two or three years. The reviews consisted not only of amending and replacing whole sections but also of re-organizing texts which in some cases, like the Civil Code of 1959 had been reformed more than twenty different times since 1990.

According to the government, the 1995-1998 review was more successful than earlier attempts. Clear timetables and programme objectives, leading up to omnibus "deregulation measures," concentrated ministries' efforts and provided greater visibility and accountability to achievements. Mechanisms were used to boost the outreach of the programme and implicate a wider public in the national effort. The Deregulation Council and the Government Commissioner commissioned from academics and researchers a series of studies on deregulation. To encourage public involvement in the programme, they launched massive public campaigns to "turn deregulation into an national event", through hearings and consultation meetings at national and regional level. They arranged a national contest in the newspapers where nearly 400 proposals were presented. Prizes of up to 100 000 Forints rewarded useful ideas. "Deregulation days" were launched, with the participation of regulators, professional organisations, and citizens, where the best presentations and proposals were published in the "Deregulatory Forum" column of the "*Magyar Közigazgatás*" newspaper.

Another successful variant has been targeted reviews, which focus on particular sectors (*i.e.* building codes) or kinds of regulations (permits and licences -- see following section on reducing formalities). In Italy, for example, independent reviews by the Antitrust Authority of general aspects of regulatory reform, such as reports about the use of licences and "concessions" restricting market access, have been useful in identifying where reform is needed, although persuading the ministries to actually reform is another matter entirely.

Failures abound. In Greece, for example, a recent regulatory review was conducted by the Ministry of the National Economy. This program, begun in 1999, systematically reviewed all regulations made over the last five years within the ministry. The assessment involved the establishment of a regulatory reform group, composed of senior officers from divisions within the ministry, who prepared the first inventory of regulations including legislation, presidential and ministerial decisions. The review concluded that all legislation, presidential decrees, and ministerial decisions within the Ministry were effective and necessary. This included the 54 ministerial orders that govern the financial sector (these make up more than half the ministerial orders for the Ministry) and the 23 ministerial orders that governed capital markets. The only negative conclusion was that more could have been done to ensure the success of the one-stop-shop investment promotion agency. The review lacked an independent and rigorous assessment of the impact of regulations, the key information needed to test regulatory quality, and instead began with qualitative statements about what the laws require. Without independent input, self-assessment rarely yields critical conclusions, which supports the argument that regulatory reform should be coordinated by a central agency or at arms-length of the ministries being reviewed. A review of business licenses is currently ongoing in Bulgaria. This process, like the one is Greece, also lacks transparency and does not sufficiently involve the business community in the discussions. Not surprisingly, of the 512 licensing regimes discussed prior to April 8, 2002, only 63 were slated for removal and 81 were revision.

Streamlining administrative process. Once the business licensing regime is reviewed and updated, some thought needs to be put into the administrative process that accompanies the obtaining of such licenses. In most developing countries around the world, and certainly in the majority of transition economies, the process that an entrepreneur needs to go through to get a license borders on harassment. This is the case in a country like Belarus, where an entrepreneur must simultaneously receive a license, a permit, and a letter of accreditation to open up a shoe repair shop (these are alongside the 20 regular steps for opening up any type of business). In several transition economies, the company registry is kept at the Ministry or Department of Statistics; while the Trade Registry is kept at the local courts. Essentially the same procedure is repeated twice, with a loss of significant time. In Bulgaria, the overall procedure for registering a new firm takes about a month, of which three weeks is taken by waiting for the court clerk to process the Trade Registry number. Such procedures are duplicative and should be streamlined.

The administrative process can be significantly improved if the latest internet based technologies are utilized. Many of the face-to-face interactions between government officials and entrepreneurs would be rendered unnecessary if applications can be processed electronically. Many countries have moved in this direction. The most successful reformers include Australia, New Zealand, Singapore, Norway and Sweden. Many developing countries have introduced electronic processing for at least some interactions between regulators and businesses. Examples include filling in electronic tax forms in Bulgaria and Slovenia. Much remains to be done.

The availability of internet technology also allows the government to provide detailed information on all the necessary requirements to formalize different types of business activity. This can be a huge impetus to reducing discretionary behavior on the part of bureaucrats and giving entrepreneurs, and more generally consumers of public services, a stronger position as they demand timely and high-quality services. Various firm-level surveys in transition and developing countries show that knowing the precise requirements and also having the government officials know you know how the administrative process is supposed to work speeds up public service delivery considerably, without reducing quality. In short, information cuts slack in the bureaucracy, as well as reduces the possibility to extract bribes.

Adopting uniform taxes. High levels of taxes and burdensome tax administration have been mentioned earlier as important determinants of the decision to stay in the informal economy. A number of countries have experimented with reforms in their tax laws and the organization of tax collection. The prevailing experience suggests that a move towards a unified corporate tax rate, set at a reasonable level, does away with much of the costs involved in filing separate tax declarations with separate agencies or separate parts of the Tax Office. Interestingly, and this is shown across transition economies as well, a unified corporate tax even if set below the prevailing average corporate tax burden, increases tax collection. This is for two reasons: the tax base is increased, as firms at the margin of the unofficial economy see their benefits of formality increase; and current tax-payers become more compliant, as it is easier for the tax inspector to spot under-reporting.

Enhancing access to capital. As mentioned earlier, because banks in the region have provided few financial services to even formal SMEs and for most part have generally ignored micro and informal SMEs, microfinance institutions (MFIs) have emerged as a source for financing for these enterprises. MFIs use specific methods that are tailored to meet the needs of these micro and small entrepreneurs such as using non-secured and unconventional collateral, "graduated lending" techniques (very small initial loans that can be increased gradually based on the client's repayment history), quick response (time between loan application to loan approval is 2-5 days), easy access, and labor-intensive loan screening and collection procedures.

For transition economies, the average outstanding balance for MFIs ranges between US$600-US$5000, indicating that these clients are small businesses. But these small numbers add up. For example, the loan portfolio of Bosnia's leading microfinance bank MEB BiH is nearly US$15 million while that of Poland's Fundusz Micro is about US$9 million.

A recent survey of the microfinance sector in the ECA region reveals that it is a fast-growing industry. Institutions providing microfinance services are less than 10 years old, with a number of specialized institutions operating for only 3-5 years (Forster and Pytkowska, 2002). Preliminary data suggests that MFI clients are growing by about 30 percent a year. This kind of dramatic growth in clientele with corresponding growth in loan portfolio and savings deposits is evidence that there is strong demand for microfinance products. Moreover, people are willing and able to pay relatively high prices (around 2-3 percent a month) to have access to these services.

Traditonally MFIs serve both the formal and informal sector businesses, thus in as sense serving as a bridge between the two. To allow for the healthy development of this sector, policymakers should focus on three key areas:

(i) Ease operating constraints on existing MFIs. As mentioned earlier, MFIs use non-traditional methods to provide services to their clients in a commercially sustainable and competent manner. To encourage non-bank financial intermediaries to provide existing microfinance services and experiment with new products, policymakers should address key elements in the legal environment that constrain the operations of MFIs in the region such as:

- Allowing for a range of institutions under various legal forms to provide financial services;

- Clearing up ambiguities related to the legal status of some non-bank financial intermediaries such as NGO-MFIs;
- Easing restrictions on activity and ownership of existing MFIs that may or may not require 'heavy' governance and internal reporting structures;
- Lowering minimum capitalization requirements depending on type of MFI (bank or non-bank financial intermediary) and services it provides (non-deposit taking MFI versus deposit-taking MFI)

(ii) Examine and change existing banking regulations to encourage small firms' lending. The formal private sector has been starved for capital. Greater access to financial services will provide a powerful incentive for high dynamic informal firms to enter the formal sector. Yet formal financial institutions are often legally restricted by prudential norms from or absence of enforcement mechanisms to lend to small firms. To encourage banks to provide financing, current regulations governing these institutions may need some changes such as:

- Strengthening debt collection laws and enforcement mechanisms
- Changing collateral laws to recognize non-traditional collateral or accept personal guarantees.
- Raising limits on unsecured lending. Typically these limits are too low to enable banks undertake non-collateralized lending.
- Improving property registration so that borrowers can use their land or house as collateral.
- Revising leasing legislation so that financial institutions can more effectively use this service.
- Lifting interest rate ceilings. Because the administrative costs of smaller loans and the risk of lending to clients without established credit history are higher, banks must be allowed to charge higher rates of interest to small firms to provide them with services in a commercially sustainable manner.
- Establishing small claims courts that will enable financial institutions to easily enforce a loan contract by seizing and liquidating assets offered as collateral.

(iii) Avoid state-sponsored financial intermediation. In transition economies and other parts of the world, government-backed efforts to provide financial and other services to small firms and informal sector enterprises have typically failed. Most of these efforts are distortionary, require huge levels of subsidy, and fail to reach the target audience. Rather than being a provider, the state should play the role of an 'enabler' that allows for private sector institutions meets these needs in a commercially sustainable manner.

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