

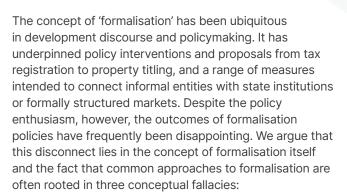
### Research in Brief

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# Rethinking Formalisation: A Conceptual Critique and Research Agenda

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**Summary of Working Paper 127** 



- a) that there is a binary distinction between formal and informal economic actors;
- b) that all informal economic actors are alike; and
- c) that 'becoming' formal necessarily spurs a set of positive externalities.

To properly rethink formalisation, we need to take into account the political and social dynamics that shape informality wherever we find it. These dynamics are rooted in the power structures that in turn shape knowledge creation in this area. Consequently, we argue for a new research agenda on formalisation that challenges both its conceptual foundations and the practices of research that engage with it.

# **Conceptual foundations**

One of the conceptual problems with the term 'formalisation' is that it is frequently used to describe and compare extremely diverse institutional linkages and processes across diverse contexts. De-contextualised inferences in turn risk misleading policymakers. The tendency to conflate different processes of formalisation is driven by three interrelated conceptual fallacies.

- Binary Fallacy: A simple formal-informal duality is frequently assumed, in which firms are either fully 'formal' or fully 'informal', separated only by the specific institutional linkage that is the object of the study. This view of formalisation obscures the myriad ways in which firms may straddle the formal-informal binary.
- 2. **Homogeneity Fallacy:** When discussing formalisation, policymakers, administrators, and analysts often make certain assumptions about what characterises an

informal firm, often settling on the image of a small, poor firm, or self-employed trader or vendor. This does not accurately represent the breadth of firms that are not formally registered or paying taxes. Without accounting for the diversity of informal economic activity and actors, analysts and policymakers are prone to make flawed assumptions about the reasons why actors remain informal in a given context, and consequently risk mis-targeting formalisation policies.

3. **Evolutionary Fallacy:** There is a tendency to assume that a specific formalisation process (e.g. tax registration) will also lead to another (e.g. use of formal banking), while also naturally leading to positive externalities (e.g. access to public services, better business performance). Without addressing the underlying structural barriers inhibiting broader formalisation, these assumed outcomes are unlikely.

These conceptual problems have led to the emergence of a 'conventional wisdom' about formalisation and its benefits that is often spurious, yet widely embraced by policymakers, particularly in low- and middle- income countries. Consequentially, the assumed benefits and positive externalities of formalisation have too often been taken as given, prompting policymakers to undertake 'formalisation' efforts with overly grand hopes of what will follow.

#### Case studies of formalisation

As a result of the flawed concepts of formalisation, hoped for outcomes often do not materialise in practice – calling into question the value of the underlying theories. To illustrate this point, we consider the ways in which the fallacies underpinning formalisation's 'conventional wisdom' act upon two key policy areas:

#### Tax registration

**Binary Fallacy** → Businesses are not simply registered or unregistered, tax compliant or non-compliant. They may be registered with one government institution but not another, and they may be likewise paying a range of small and informal taxes and user fees but not paying taxes to the national government.

**Homogeneity Fallacy** → By failing to distinguish between smaller and larger informal businesses, formalisation

efforts underperform in revenue collection with negative equity implications.

**Evolutionary Fallacy** → Assumed positive firm-level benefits do not necessarily follow from registration because of the diversity of actors in the informal economy and the diversity of barriers to accessing those benefits.

#### **Property Titling**

**Binary Fallacy** → Dominant views of property titling frequently uphold a narrow and simplistic construction of legality, of the difference between 'formally' and 'informally' held land, and of the diversity of each – with implications for the value of 'dead capital' that is estimated to exist.

Homogeneity Fallacy → While property titling programmes are frequently framed as 'pro-poor' interventions, in practice they have been associated with substantive equity issues. The mismatch between the assumed and the real beneficiaries of titling programmes connects to a simplistic understanding of who holds informal property, what their motivations are, and the diverse contexts and power dynamics in which they are embedded.

**Evolutionary Fallacy** → Empirical evaluations of property titling reveal that the benefits assumed to follow (e.g. improved access to credit) are not assured.

## A research agenda for formalisation

There is often a 'technocratic tendency' in formalisation research, with international development partners, researchers, domestic policymakers, and public sector administrators prioritising evidence and policy interventions that are presented as 'apolitical' and are insufficiently contextually grounded.

A better conceptual approach to formalisation must be:

a) Relational, recognising that formalisation processes change not a feature of the firm or individual, but the

- relationship between an actor and a state structure.
- b) Conditional, understanding that a specific process of formalisation refers to only a subset of individual, firm, or institutional relationships, and rarely all of them. Research, results, and recommendations on formalisation should therefore specify the types of connections affected and situate them in their wider context.
- c) Political, with formalisation processes best analysed in the context of the wider political economy of a particular affected activity or population, rather than being seen as mere technical 'upgrading' or organising.

These conceptual shifts need be accompanied by different methodological approaches:

- There is a need for more genuinely bottom-up or interpretivist explorations of formalisation processes that can inductively generate new concepts and observe dynamics rather than merely field-test dominant hypotheses.
- 2. There is scope for more mixed-methods approaches to the study of informality. Combining a rich contextual understanding of the meaning and dynamics of informality in a given context with the rigour of statistical policy impact evaluations to inform policy will produce research that is both evidence-based and grounded in reality.
- There is a need for work that situates formalisation processes within wider questions of power and citizen-state relationships and that looks beyond firmlevel and rational choice perspectives.

If done well, formalisation represents a targeted but ongoing process of engaging with individuals and firms. To reap its benefits, however, formalisation needs to be understood as one aspect of a wider set of policies that connect states and informal economies, rather than as a 'rationalising' silver bullet.

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