

Understanding the Theoretical Foundations Underlying the Formalization of the Informal Economy

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The objective of this article is to contribute to the deepening of knowledge on the theoretical foundations of formalization, based on a literature review in order to identify the paths of formalization. The present analysis shows that working in the informal sector is a rationally motivated decision of the entrepreneur. One of the solutions lies in the efficiency of the services provided by the State, given that the payment of taxes does not give the right to a simultaneous counterpart. It also shows that both the state and the entrepreneurs benefit from cooperation. Thus, their relations must be governed by an optimal contractual relationship for the successful formalisation. It has also been shown that micro-enterprises are subject to inadequate legislation, hence the need to revise the legislation in force. Also, the lack of support from the financial system and training programs adapted to the specificities of the enterprises would constitute fewer factors of production. Thus, it is desirable to improve the access of informal entrepreneurs to these productive resources.

Keywords: understanding, theoretical foundations, formalization, informal economy

INTRODUCTION

Since the 1970s, developing countries have experienced high population growth and urban sprawl due in part to the exodus of rural populations to the cities, which, as a result, will lead to a proliferation of informal activities in response to an excess supply of labor in the urban economy (Kraiem, 2015). The informal sector has thus gradually become the main job creator in the face of underemployment and amplified unemployment.

The proliferation of informal sector activities is mainly due to the underperformance of the formal sector in the face of the crisis or structural adjustment policies which, as a result, can no longer absorb the surplus labor in the labor market (Rakotomanana, 2011). Even in SSA, where economic performance in a context of relative macroeconomic stability and poverty reduction has been recorded, the informal sector remains predominant. This predominance is also attributable to the failure of labor absorption mechanisms by the formal sector. These factors are compounded by the failure of imported industrial development models.

Today, this sector presents itself as the main mode of insertion, the only provider of jobs and income in a context of recurrent economic crises and structural adjustment. This naturally arouses the interest of many researchers and policy makers in the informal sector. As a result, since the recognition of its role in developing countries, much work has been devoted to the small-scale activities brought together under this concept (Marniesse, 2000) and advocates their formalization.

The question “why should it be formalized?” would have received a massively empirical answer in the research world. Formalizing enterprises seems to be a natural way to improve the incomes of entrepreneurs who are generally vulnerable. Major investments in formalization programs are being implemented in many Sub-Saharan African countries.

In spite of this, many studies criticize formalization strategies for being based on simplistic and ill-adapted views. Some African policies ignore the concrete conditions and negative effects of formalization operations on the social, political and economic levels. Substantive criticisms focus on the structurally ambivalent nature of the conceptual framework of formalization. Without claiming to settle the debate, this article proposes to theoretically trace the furrows of formalization in order to put into perspective the policies of firm registration with regard to the failures of formalization policies.

Moreover, few studies have focused on the foundations of formalization or are not sufficiently developed. This knowledge remains not only indispensable for good empirical developments, but also for the successful implementation of economic policy implications. In addition, these foundations provide a better understanding of the behaviour of economic agents, particularly their attitude towards formalization.

To do this, it is important to analyze the theoretical developments inherent in formalization with a view to developing better strategies. This is what motivates the writing of this article, which reviews the theoretical foundations of formalization, the paths of formalization in economic thinking and the incentives for formalization.

THE THEORETICAL BASIS OF FORMALIZATION

Arguments in Favour of Formalization

In the literature, several arguments have been mobilized to support formalization, including the negative implications of informality. Thus, several analysts have set out to explain that the loss of productivity and growth generated by informality constitutes an essential argument for formalizing it.

Theoretical approaches, which underpin the pessimistic vision of the relationship between the informal sector and development, consider the informal as a source of loss of growth and productivity, and therefore of well-being. Indeed, productivity is considered by some authors as an index of long-term well-being (Nordhaus, 2001 and Krugman, 1990).

However, in the long run, a country’s rate of economic growth depends largely on its capacity to increase its productivity. Thus, the increase in total factor productivity is considered to be responsible for a third or even half of a country’s per capita GDP growth rate (Kraiem, 2015). Moreover, according to a study by Eilat and Zinnes (2002), the informal sector is negatively correlated with growth. Indeed, a 10% reduction in official income is associated with a 31% increase in the share of the informal sector, whereas a 10% increase in official GDP leads to a 25% drop in informal income.

Studies by the Peruvian Institute of Liberties and Law, chaired by De Soto (1994), reveal that the productivity level of informal firms is one third of that of formal firms. Perry et al (2007) conclude that the productivity level of firms that started informally but eventually registered is higher than that of firms that started and remained informal. Loayza (1997), using an endogenous growth model, showed that the expansion of the informal sector is negatively correlated with overall economic growth. Due to its low level of productivity and high transaction costs, the informal sector seems to be a blocking factor for economic growth in the long term.

Proponents of legalistic theories suggest that the informal sector, through its congestion effects on public services and goods, contributes not only to reducing tax revenues, but also to the deterioration of the quality of these services, thus hindering potential productivity growth. On the other hand, a contraction of the informal sector leads to an increase in tax revenues, which in turn leads to increased public spending, for example on infrastructure and services. This contributes to the expansion of output and thus leads to an increase in the overall economic growth rate.

Furthermore, some analysts have concluded that despite its huge share in developing country economies, the informal sector largely escapes taxation. It is a source of tax evasion (OECD, 2004). Moreover, the expansion of the so-called informal economy to a certain proportion can trigger a vicious

circle of lost tax revenue and higher tax rates. By failing to meet their tax obligations, informal firms reduce the tax base and increase the burden on formal firms.

Besides, excessive informality contributes, through its congestion effects on public goods and services, not only to reduce tax revenues but also to limit the capacity of the state to increase public investment. The informal sector contributes to deteriorating the quality of public goods and services or to causing shortages of them, which in turn hampers productivity growth (Bacchetta et al., 2009).

In turn, proponents of structuralist theory point to the negative effects of informality on productivity and growth. According to them, despite the fact that it ensures a certain reproduction of cheap labour and provides cheap goods through the subcontracting system for capitalist firms. This can lead in the long run to increased competition in certain market sectors. Also, it can limit profit margins and affect the possibilities of capital accumulation necessary for the economic growth of the country.

Regarding competition, other analyses have shown that informal firms that do not meet their tax and social security obligations compete unfairly with formal firms and gain market share at the expense of formal competitors. Moreover, the expansion of the informal sector, as a result of this unfair competition, deprives governments of fiscal resources, reduces the size of state budgets and limits the ability of the government in power to extend social protection schemes and develop public services essential for economic growth (ILO, 2013; 2002).

Informal work is, moreover, associated with low labor compensation and generally paid below the minimum wage. Informal entrepreneurs are not registered with the country's official structures; they are not subject to any regulation and are not protected by labor and social protection legislation. They do not enjoy any trade union rights that would allow them to claim their basic rights.

At the level of globalization, proponents of this approach note that the informal sector can be detrimental to the results of trade. For example, informal enterprises are often too small to take full advantage of economies of scale. Studies show that high levels of informality place countries in the lowest and most vulnerable segments of global production chains and attract capital flows linked to the existence of a large pool of cheap labour (Bacchetta, 2009; ILO, 2013). As a result, the informal sector negatively influences the country's ability to benefit from globalization and generate growth.

The informal sector is exposed to a high risk of corruption. There is evidence that the expansion of the informal sector fosters corruption in developing countries. Indeed, informal firms are more exposed to corruption than formal firms. Formal firms can report corruption to the relevant authorities, while informal firms are more willing to accept bribes for fear of attracting the attention of the authorities and facing financial penalties (Friedman et al., 2000).

Corruption generally has a negative impact on a country's economic performance (Mauro, 1995; Méon and Sekkat, 2005). As a result, it negatively affects economic growth, the level of investment in the country and the development of the formal sector (Friedman et al., 2000; Ouedraogo, 2015). Moreover, it constitutes a significant cost for informal firms.

Constraints to Formalization in the Dominant Schools of Thought

The legalistic, neo-liberal and structuralist currents are the main theoretical approaches that analyze formalization. According to this legalistic theory, firms do not formalize because of barriers to entry into the formal sector. In fact, the formal sector is too rigid and subject to numerous taxes. Depending on the level of taxation, control and fines, the share of the so-called informal economy is more or less strong (Cebula, 1997).

The proponents of this thesis consider that the weight of state rules and administrative constraints on micro-enterprises discourages initiative, and micro-enterprises discourage the formalization of their existence. They argue that once these regulatory constraints are lifted, informal enterprises would integrate the formal economy and profitably participate in economic growth. Informal enterprises, they believe, are potentially profitable, but their development is hindered by public policies. They argue that excessive bureaucratic regulations and high tax rates and payroll taxes reduce the profit margin of the formal sector and encourage entrepreneurs to move into the informal sector (Loayza, 1997 and De Soto, 2000).

In the same vein, the neo-liberal approach pioneered by De Soto (1989) argues that if entrepreneurs choose to operate informally, it is because the laws enacted by the state are binding. Thus, she condemns the “bad laws” used by politicians to maintain their grip on the economy, which creates problems “both in informality and legality.” This approach maintains that state intervention in economic activities is merely a form of confiscation of individual freedom to carry out an activity.

State intervention is seen by proponents of this approach as a mechanism that prevents optimal production from being achieved. Thus, keeping companies in the informal sector would reflect the deliberate desire of economic operators to escape this yoke and regain freedom. This explains, according to neoliberalism, the fact that a good part of operators turn their backs on the State and categorically display their reticence with regard to administrative registers. Indeed, they seek to escape the weight of legality in order to adopt new productive strategies to maximize their profit.

Moreover, the neo-liberals propose that the fiscal objective of registering activities to feed common resources should disappear. They opt for a “simplified” or “de-bureaucratized” and “decentralized” civil service. According to them, economic activities should be deregulated in the sense that the state should disengage itself completely from them. Because, for them, it is better to give everyone the means to achieve their own objectives rather than to collect resources for common projects.

Contrary to the legalistic approach, structuralists defend that state rules and institutions can be circumvented because their scope is too limited. The fact that rules are not respected is rather a sign of the weakness of these rules and not of their weight and excess. As a result, the informal sector is still influenced by the inefficiency of state services (social protection, compliance with labor laws, taxation, etc.).

In addition, excessive regulation is not the only problem that prevents informal firms from formalizing, but the latter suffer from the lack of support from the financial system and training programs adapted to their specificities (low level of education, lack of guarantees, low investment) (Lapeyre and Lemaître, 2014). Non-registration therefore appears to be independent of the operators’ will and is largely the result of administrative, economic, social and geographical constraints.

Advocates of the structuralist approach recommend structural reform of public registration services to make them more efficient and more easily accessible. The aim is to make the processing of files shorter and less costly, with less corruption and more transparency: low financial cost, simpler procedures and closer services.

Finally, the last research perspective can be described as institutionalist. It focuses on the effect of the institutional environment on entrepreneurs, with institutional constraints constituting sources of transaction costs (North, 1990, Acemoglu, 2007, Talbot, 2008). These studies seek to demonstrate that government institutions (represented by legislation, regulations and administrative culture) tend to increase transaction costs (De Soto, 1994; Afibefun and Daramola, 2003).

Indeed, these studies observe that, in most African countries, the capacity of governments to impose regulatory constraints on informal business activity is limited (Trip, 1997; Heilman, 1998). In seeking to legislate in this area, the main government-induced effect is to put the legal status of a large number of small firms out of reach. This seems to confine them to the formal sector because the legislation would be established for seasoned entrepreneurs of large public and private enterprises and not for small entrepreneurs.

Institutionalists have shown that, while being a low-cost refuge, informal entrepreneurs benefit from growth opportunities, even if formal institutions do not recognize their formal existence or the forms through which they accumulate capital. This is true because small firms are embedded in the gaps left by large ones and thus find opportunities to exist and grow.

This research concludes that, in general, public authorities exclude these micro-enterprises from access to the resources essential to their simple operation or growth. Access to these cultural, human and financial resources (capital, technology, training and opportunities) is at the heart of the challenges of the informal economy (De Soto, 2000, Aryeetey, 2009, Samson, 2012).

Formalization Rationality Logic

Neoclassical approaches identify cost-benefit analysis as a determining factor in the decision making of workers and enterprises to move out of the formal sector to create informal micro-enterprises. Micro-entrepreneurs will always seek to be in informality as long as formalization has lower benefits relative to costs (Bacchetta, 2009).

In this vein, some authors consider that the choice between the informal and formal sectors is only made after comparing the costs and benefits of formalization versus informal status (Perry et al., 2007; Djankov et al., 2002; Loayza et al., 2005; Ishengoma and Kappel, 2006; Friedman et al., 2000).

The micro-entrepreneur, reasoning homo-economically, will compare the temporal and financial costs of formalization to the costs of informality with its corollaries (lack of access to advertising, lack of access to bank credit and public procurement, corruption of police and controllers, etc.) and will ultimately draw the simple conclusion that the costs of formalization far exceed those of informality and therefore will undoubtedly opt for the latter.

Microenterprises therefore opt for extra-legality, which is a survival strategy in the face of administrative and bureaucratic obstacles. De Soto (1989) distinguishes between “good laws,” which guarantee and promote economic efficiency, and “bad laws,” which protect a privileged minority by limiting access to economic activity and thus hinder economic efficiency.

Following these logics, the decision to formalize or not to formalize is perceived as a rational choice of the entrepreneur to optimize his gains. There are trade-off effects between the costs of remaining outside the law and the benefits of investing in an unregulated sector, due to the absence of taxation and administrative burdens (Dabla-Norris and Stein, 2005).

Based on the hypothesis of individual rationality, authors argue that the decision to formalize an informal firm is guided by the difference in utility between these two statuses (Hammouda et al., 2009). Thus, any rational operator would opt for the formalization of his firm if the expected utility of the formal status exceeds that of the informal status and vice versa (Johansson, 2000).

In contrast to proponents of traditional approaches, proponents of formal sector exit theory, including Becker (2004) who has conducted surveys in Latin America, argue that informal employment is a matter of individual choice (Salem and Bensidoun, 2011). Perry et al (2007) in a study piloted by the World Bank, recently revisited the informal sector, based on Hirschman’s (1970, 1981) theory of “voluntary withdrawal.” They analyse the mobility and choice of activities of individuals (formal, informal, pluriactivity), according to the rational logic of the micro-entrepreneur, who would freely and consciously evaluate each situation in terms of the “costs and benefits” of informality, and who would assess it according to the interest he or she may have in leaving it.

From this perspective, the choice to leave informality is strongly influenced by the efficiency of state services (social protection, compliance with labor legislation, taxation, etc.). Thus, state rules and institutions can be shunned because their scope is too limited and therefore because of their weakness and not because of their weight and their too great importance as in the legalistic approach.

Moreover, some entrepreneurs and employees prefer to work in the informal sector after assessing the advantages and disadvantages of formality (OECD, 2009). This choice is made with the aim of maximizing their usefulness according to their individual characteristics and preferences. The latter include, beyond financial aspects, elements such as autonomy, flexibility, home-work distance and other job-related opportunities. Within this framework, workers voluntarily opt for informal employment that better corresponds to the factors that are specific to them and whose attributes they value (Rosen, 1986).

According to proponents of this theory of exit from the formal economy, although the worker’s preference is above all for formal employment, informal jobs can just as easily be better paid than formal jobs to compensate for the lack of social security coverage or their greater precariousness (Salem and Bensidoun, 2011).

Maloney’s (2004) explanation of voluntary informal employment is similar to Fields’s in many respects, but differs in its emphasis on formal social protection, which is both a defining characteristic of formal employment and an incentive to work informally.

Indeed, if a family is eligible for health coverage, if one member is in formal employment, the other members of the family have less incentive to work in the formal economy. Another case where workers may be tempted to opt out of mandatory pension contributions is when their immediate cost may seem too high compared with an uncertain future benefit (Kucera and Roncolato, 2008; OECD, 2009).

Furthermore, it points out that the commonly accepted idea of a preference for formal jobs because of social security coverage may not correspond to reality or at least not be appreciated in the same way by workers in countries where the services offered may sometimes be of lower quality, despite their high cost. Because of its poor quality, social protection is then perceived as a tax rather than an insurance policy, a tax that workers seek to avoid. Thus, workers, with very few resources, consider it too expensive to put aside savings for later (Maloney, 2004).

This author makes it clear that this view does not necessarily mean that informal workers are more prosperous, but simply that they feel better about it. Several explanations can be given for this choice, such as women who find informal employment more flexible and more advantageous in that it allows them to better reconcile family and professional life, or even some young people with little education who benefit from acquiring initial work experience before entering the formal labour market (Cotnoir, 2011; Lucas, 1978). From all of the above, it is clear that workers are not always forced to work in the informal sector.

More fundamentally, the notion of willingness implies the possibility of choice: informal workers described as “volunteers” could in fact benefit from formal employment if they so wish (Jutting and N De Laiglesia, 2009). This choice involves a trade-off between the costs and benefits of formal and informal status. The preference for informality in developing countries under this approach is attributed both to market failures and to the poor quality of the state institutions that frame these markets (Treiller, 2013).

Formalization as a Positive-Sum Game

The analysis of the relationships between these two main actors of the formalization leads to ambiguous results. For some, it is the weakness of the State that does not allow the effective control of all economic activities on the territory. Indeed, the weakness of the financial, technical and human resources (in number and quality) is the fundamental reason for this. However, informality is also the non-respect of norms enacted or imposed by the State, among others, the payment of taxes, social contributions, the keeping of basic accounts, the respect of the law, etc.

As De Soto (1989) states, this non-compliance with legal norms is the result of excessive regulation and fiscal pressure that pushes entrepreneurs to take refuge in the informal sector. “The fact that informal firms escape taxation can trigger the vicious circle of lost tax revenue and an increased tax burden on other firms.”

Formalization as Positive-Sum Game

However, higher taxes are likely to erode the productivity advantage of large formal firms and the incentives to innovate and invest (OECD, 2009). On the other hand, Roubaud (1994) disapproves of this view, which is poorly accepted in developing countries. One of the reasons put forward is that the State creates distortions in the economy and too much State is a brake on the formalization of the informal economy.

This situation fundamentally poses the problem of the relationship between the citizen and the State. Indeed, the relationship between the entrepreneur and the State can be interpreted as a contract binding both parties. The entrepreneur, by committing himself to respect the established rules of the game, “hopes or demands” that the State also fulfills its contractual commitments, namely the establishment of governance conducive to business management on the one hand, and efficient and effective public services on the other. The reality is very far from this ideal figure. Thus, the State and informal entrepreneurs pursue complementary objectives (the State advocates formalization and operators are looking for performance), but each paradoxically expects incentives from the other.

The solution can be found in the mutual respect of the commitments made by each of the agents. For, the State needs to levy taxes and other charges to provide quality public services and viable infrastructures and to assume its redistributive functions in order to erect safety nets for the weakest and create a favorable

business environment. But, if taxes are too high, no economic agent, even the most altruistic, will be inclined to work to give everything back to the state. No one has the incentive to produce more unless they are certain that they can obtain a sufficiently remunerative return from their work (Mouko, 2015).

Given that the search for performance and formalization are not contradictory objectives, and in view of the tax losses generated by the informal sector and the beneficial effects of formalization on the performance of firms, it is necessary to find mechanisms that can encourage firms to formalize.

The willingness of micro-entrepreneurs to pay the various taxes and duties, as well as their submission to the regulations in force resulting from the formalization process of informal enterprises, can be interpreted, at this level, as a contract with the central government or its subdivisions. The latter recognize the latter's property rights and freedom to dispose of the earnings from their operations. The New Industrial School (NEI) or the economics of conventions raises three fundamental concerns. These are the question of transaction costs, incentives and benefits of cooperating with the state (Coase, 1987, 2005; Nelson and Winter, 1982; North, 1990, 2005; Williamson, 1986, 1994).

The formal sector will then be defined as any activity adhering to the "rules of the game" or benefiting from their protection. Conversely, agents who do not adhere to the rules or who refuse this protection will be included in the informal sector. The heterogeneity of the informal sector is then based on the variety of institutions that can be bypassed. Finally, the relative weight of the two sectors in an economy will result from the difference observed in transformation costs and transaction costs (Montalieu, 2001).

The willingness to cooperate and coordinate makes it possible to achieve several combinations of gains between "protagonists" (the State and informal operators). In 1950, John Forbes Nash demonstrated that any non-zero-sum game for n people has at least a Nash equilibrium in mixed strategies. By considering the state and the operator of the informal as the two players, the sum of the game will be positive in the formality. The idea is that at this level, both players win, unlike in a zero-sum game where the loss of one is the gain of the other. Schematically, the configuration of the protagonists' gains according to their willingness to cooperate in a contractual relationship can be established as follows in Table 1.

**TABLE 1
GAINS FROM THE CONTRACTOR'S COOPERATION WITH THE STATE**

		STATE	
		Cooperates	Does not cooperate
INFORMAL ENTREPRENEUR	Cooperates	Win-Win	Win-lose
	Does not cooperate	Lose-Win	Lose-Lose

Source: Author, inspired by Mouko (2015)

THE WAYS OF FORMALIZATION IN ECONOMIC THINKING

The neoclassical solution lies in the elimination of irrelevant administrative and regulatory barriers to the creation of micro-enterprises and productive activities. It also implies the withdrawal of the State from the market, in order to allow the actors of the informal sector to work in synergy for the creation of goods and services necessary for the economy. Faced with inadequate and inappropriate laws, the State must imperatively review the legislation relating to micro-enterprises to adapt it to the economic reality.

Therefore, according to H. De. Soto, (1989), it makes more sense to adapt the law to reality than to try to change behaviour. According to De Soto, the development of the market and informal economy depends on the simplification of the law governing micro-enterprises in order for them to flourish. These simplifications and modifications imply the removal of restrictive regulations (labor law, taxation, administrative procedures) and their replacement by "facilitative legislative instruments."

De Soto's proposals consist of formalizing informal enterprises through a "minimum law." It would thus become the model of the flexible society since it is only subject to the constraints that serve its efficiency. Taken to extremes, proposals in favor of a non-State lead to a pure and simple dismantling of social protection and job guarantees in the civil service and the private sector.

Such a stance is highly questionable since the State can skillfully combine the binomial of social coverage and informal flexibility. The State can establish specific and adaptable regulations (administrative, social and fiscal) specific to the informal sector and according to the financial capacities of micro-enterprises. It can, in the same logic, subsidize part of the social security coverage of informal employees, given that micro-entrepreneurs cannot cover all the social charges for their employees, let alone ensure quality services.

For the neo-classical microeconomic approach, the emergence of the informal sector was the result of the perverse effect of excessive regulations, the administrative burden in obtaining the documents required to carry out such an activity and the social repercussions of legislation. The neo-classical micro-economic approach perceives micro-entrepreneurs as rational actors seeking to maximize their income. The decision to seek refuge in the informal sector is the result of a rational assessment of the costs and benefits. Improving the benefits in the formal sector is the ideal solution to attract more informal activities to formalize.

The predominance of liberal ideas in the 1980s contributed to a large extent to the acceptance of the withdrawal of the state from economic activities. Critics of this approach note, however, that the withdrawal of the State in Africa and Latin America in particular, and its almost insignificant intervention at the economic and social level coupled with its inability to control, are at the root of the development of the informal sector (Roubaud, 1994).

This author indicates that, if the micro-economic approach is relevant for certain segments of the informal economy, where many micro-enterprises, in order to escape the increasingly overwhelming regulatory (social, fiscal and administrative) constraints, choose the extra-legal framework, it is totally unfounded for the other segments where it is paradoxically the weakness of the welfare state that is at the origin of the non-registration of these activities.

Critics of this extreme legalist stance, combined with a rational approach to socio-economic problems, suggest that too much state is harmful to the informal sector, but too little state remains catastrophic. The solution would be the optimization of public intervention.

According to the legalistic approach, state rules and institutions can be leaked because their scope is too limited. The fact that rules are not respected is rather a sign of the weakness of these rules and not of their weight and excess. As a result, the informal economy is still influenced by the inefficiency of state services. Moreover, the excess of regulations is not the only problem that prevents informal enterprises from formalizing, but the latter suffer from the lack of support from the financial system and training programs adapted to their specificities (low level of education, lack of guarantees, low investment) (Lapeyre and Lemaître, 2014). Improving access to credit and to the training program is thus to be encouraged in order to boost formalization.

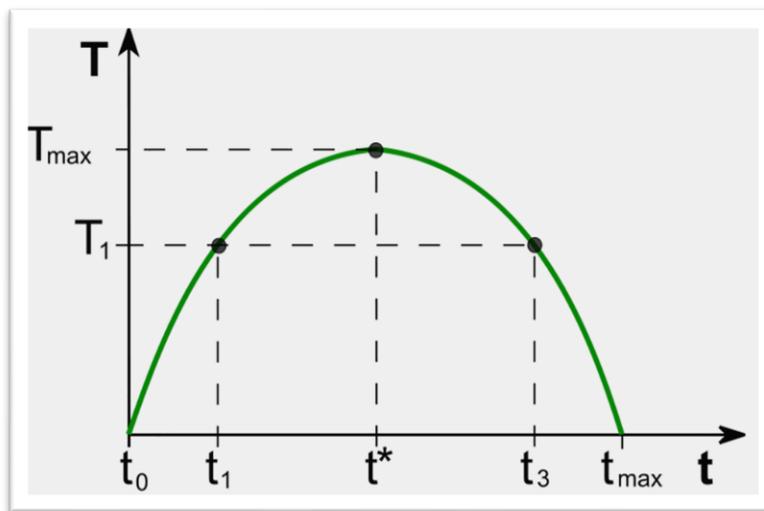
For the neo-liberal approach, the informal sector is the ideal framework for pure and perfect competition. Indeed, the urban informal sector is the place where pure and perfect competition develops, hampered in the modern sector by numerous obstacles created by the State (De Soto, 1994). Potential entrepreneurs who cannot bear the costs of formalizing their firms have no choice but to take refuge in the informal sector. The informal economy is thus, from this point of view, "barefoot capitalism" (in Fonteneau et al., 1999).

Drawing on the results of field surveys, De Soto explains that the informal sector is essentially a response to the excessive weight of the State. Taxes and taxation as well as slow and cumbersome bureaucracy are obstacles to the legal creation of enterprises. Therefore, improving the business environment is an important provision to encourage formalization.

Moreover, as Laffer shows, too much taxation by the State leads to tax losses. It shows the importance of tax attractiveness in terms of formalization. Also, when tax rates are low, this can lead to the establishment of new companies and thus increase the tax base. A hypothesis is made on the rationality of economic agents: when the tax rate is too high, agents reduce their work.

Taken to the extreme, this reasoning implies that agents would stop working if the tax rate was 100 per cent, that is, if they received no wages for the work they did. The level of the tax threshold, above which agents reduce their labour supply, is difficult to establish and depends on living conditions. This conception of Laffer's is known from the formulation "too much tax kills tax." Thus, low tax rates prove to be a necessary condition for the formalization of informal firms.

FIGURE 1
ARTUR LAFFER CURVE



Source: Arthur Laffer , 1970

INCENTIVES FOR FORMALIZATION

Incentives based on earnings expectations and those based on individual performance have found a prominent place in theoretical analyses.

Incentives Based on Earnings Expectations

The question of incentives is central to the analysis of agent behavior, whatever the mode of organization. It takes on particular importance in integrated organization and, to a lesser degree, in hybrid arrangements in relation to markets. In the latter, there is indeed a strong correlation between the actions undertaken and their rewards. This is what neoclassical theory synthesizes under the theme of profit maximization. The adequacy of profit-earnings is much less assured in other modes of organization.

Incentives are defined here as the set of devices that call on the expectation of a gain, generally "monetizable," devices set up to induce agents to reveal the information they hold and to act in conformity with the objectives set on the basis of this information. The reference method is that formed on the basis of this information. The reference model is that of the principal-agent relationship: the incentives must lead the agent to reveal information enabling the principal to define an optimal contract leading the agent to do what is expected of him.

The first models developed in this perspective do so within the framework of a hierarchical organization. Weitzman (1974) examines how a central planner can avoid wasting resources by introducing a profit-sharing rule conditional on the use of these resources.

A little later, Groves and Loeb (1979) focus on how a center can lead the units under its direction, typically the divisions in a large company, to make judicious use of available resources by making their information disclosure speech. These incentive mechanisms are effective under strong assumptions,

particularly the existence of well-defined objectives and relatively homogeneous participants; and in both cases, the amount of information required is considerable.

There are two complementary challenges to relaxing these assumptions: information asymmetry and heterogeneity of agents' preferences. Two possible approaches then emerge. In the first case, which is that of classical agent models, we attribute to agents an extended rationality that intervenes in an environment where efficient markets dominate. The recommended devices are then essentially concerned with the means of reducing information asymmetry, for example by using "tournament" type mechanisms. It is these arrangements that are examined in this section.

In a second case, the focus is more on the heterogeneity of agents and on how to use their motivations to induce them to cooperate. The literature endorsing this option, which often refers to a limited rationality of agents, is developed by Akerlof and Kranton (2008), as well as other works dealing with the role of organizational culture.

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Incentives Based on the Measurement of Individual Performance

Ideally, the problem of providing incentives for agents to cooperate could be easily solved if their individual contributions could be unambiguously measured. This is the hypothesis underlying the principle of remunerating factors at their marginal productivity. Piecework remuneration, advocated by "Taylorism" (also called "Fordism") in the nascent automobile industry, or modern firm organization, is at the center of contracts based on performance measurement.

Let us take up again the principal-agent model introduced with regard to the contract. We consider the two parties, with separate preferred functions. holds a specific asset that the agent can provide, in an environment where the agent does not control the states of nature. We had summarized these conditions of production by the relation :

$$y = f(a, \theta)$$

Let's simplify the reasoning by retaining the linear case:

$$y = a + \theta$$

(with a and θ measurable in a common unit).

In order to lead the agent to undertake the actions in accordance with his interests, the principal proposes a contract among a possible set. Either for example a contract proposing a remuneration such as:

$$s = k + \beta y$$

where k is a fixed component and β a parameter determining the proportion of the product y (in value) that will revert to A . Think of a piecework wage coupled with a minimum wage.

The principal p can expect to earn a profit:

$$\Pi = y - s$$

Assuming the principal is risk-neutral, it will seek to maximise $E(y - s)$. On the other hand, the agent who accepts the contract must undertake an action that has a cost, such as the effort required so that the unit he or she gets out of it will be: $U = s - c(a)$

The convex cost function is assumed to have an increasing marginal cost of effort: it is more tiring to increase one's effort when one already works fifty hours than when one works thirty-five hours. If it is calculating and risk neutral, the agent will seek to maximize $(E(s) - c(a))$.

Within the framework of such a model, and under certain conditions, the mathematical solution determining the optimal value * of the effort that the principal can lead the agent to provide, defines in principle the optimal contract. In principle, this contract can lead to significant distortions, for theoretical and empirical reasons (Gibbons, 1998).

Firstly, the shape of the cost curve $c(a)$ plays an important role in the result; however, biconcave shapes cannot be excluded a priori, for example a bent function. Furthermore, high values β create strong, but not always desirable, incentives. On the one hand, they mean that the principal agent gives up a large part of the output, which may, for example, handicap the possibility of future investments; on the other hand, a high value of β may mean that the agent assumes an increasing share of risk, as his or her salary becomes very dependent on output.

If it is risk-averse, the contract can become counterproductive: this is the classic arbitrage between the incentive function and the contract insurance function (Sappington, 1991). Empirically, the measurement of y , on which part of the remuneration depends, may prove very difficult or give rise to manipulation on the part of the principal if it is not observable by the agent. It can also induce negative effects: an agent may have made the same effort as a colleague, but obtain a lower result because of a state of nature (for example, the malfunctioning of a machine) that he or she does not control. Given that economic agents respond to incentives, appropriate incentive mechanisms could ensure the formalization of informality.

Conclusion and Implications

Migration from the informal to the formal sector is desirable in all emerging economies. However, public policies are still hampered by enormous constraints, notably the logic of individual rationality. Aware of the shortfall induced by informality and the related job insecurity, most African countries have put in place many policies that have so far not led to a transition from the informal to the formal sector. However, the excessive weight of the state and its inability to enforce regulations are major impediments to the formalization of the informal sector, although certain characteristics of informal production units work against formalization.

The present investigation theoretically admits that the choice between the informal and the formal sector is made only after comparing the costs and benefits of formalization. Consequently, workers are not always forced to work in the informal sector. It is clear that no economic agent, even the most altruistic, will be inclined to work to pay everything back to the state. Thus, the solution can be found in the mutual respect of the commitments made by each of the agents. From a gambling perspective, the analysis reveals a positive-sum game that is profitable for both agents. This implies an encouragement of cooperation between the State and entrepreneurs in a contractual relationship.

Moreover, it has become imperative to revise the legislation relating to micro-enterprises in order to adapt it to the economic reality. However, overregulation is not the only problem preventing informal enterprises from formalizing, but they suffer from the lack of support from the financial system and training programs adapted to their specificities. In addition to improving informal entrepreneurs' access to productive resources, incentives should lead the agent (the entrepreneur) to reveal information that allows the principal (the State) to define an optimal contract that leads the agent to do what is expected of him, given that economic agents respond to the incentives.

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