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## Informal entrepreneurs create jobs. Here's how to support them

*Informal firms provide between 60 and 90 per cent of non-agricultural employment in emerging markets. This type of business exists everywhere, but it's in developing countries that the highest rates of informality and informal new firm creation are found. **Saul Estrin, Maribel Guerrero and Tomasz Mickiewicz** write that governments should not simply tolerate informal entrepreneurship but turn it into an attractive option.*

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Gianinna Osorio is a real estate broker in Chile, and the founder of [Inviertefeliz.cl](https://www.inviertefeliz.cl). Her company offers free financial, real estate and tax advice for real estate investment, generating over US\$ 80,000 per month. Her motivation stems from her childhood, when her family's lack of financial education led them to go bankrupt three times.

These experiences inspired her to educate and guide others in financial education and real estate investment with the goal of empowering people to control their financial future. Initiatives like Gianinna's can help support informal entrepreneurs and firms, champion policy actions and support sustainable development.

## Informality vs formality

Informal firms are not registered and operate under the state's radar. Although the informal sector exists in all economies, the highest rates of informality and informal new firm creation are in low-income and emerging markets such as Sub-Saharan Africa, Latin America and South Asia, where they provide between 60 and 90 per cent of non-agricultural employment.

The distinction between formal and informal firms is not the only one. Entrepreneurship can also be divided into that motivated by business opportunities and that driven by necessity, when lack of attractive employment prospects lead people to create firms.

The dominant view of new firm creation has been focused on the concept of “dual economy”, in which there is a conflation of informality and necessity motivation, associated with low human/financial capital and productivity, and formality and opportunity motivation, associated with positive benefits for growth and development. But we propose a new classification

## A new typology of new firms

We propose four instead of two categories of new firms. The first two are consistent with the standard “dual economy” model, the other two aren’t.

**Type 1:** Informal/necessity new firms are created to make ends meet. They’re created by people with lower income and educational background who face challenges entering the job market. These firms are low-productivity businesses.

**Type 2:** Formal/opportunity new firms are created by higher-income/educated individuals and generate positive benefits for growth and development.

**Type 3:** Informal/opportunity new firms are created by higher-income individuals who explore informality as a mechanism of testing their business ideas or learning about a business opportunity with a lower entry cost.

**Type 4:** Formal/necessity new firms are created by higher-income individuals who find the formal path more attractive, even if their initial motivation is related to necessity.

In our research, we use elements of the theory of occupational choice and pay particular attention to the individual’s income at the beginning of a new firm’s formation in Chile. We find that higher-income individuals often choose either *formal/necessity* or *informal/opportunity* paths to entrepreneurship, which is inconsistent with the “dual economy” perspective.

The extended classification helps to explain changes to entrepreneurial activity over time. We observed that in response to a crisis (the COVID-19 pandemic), lower-income individuals will engage more in *informal/necessity* entrepreneurship. In parallel, the number of *informal/opportunity* new firms started by higher-income individuals will decline.

## Proposed guidelines

Informal entrepreneurship is complex, due to its varied causes and forms, which also differ from country to country and even within nations. Our research suggests guidelines for policy design and policy actions to address informality.

### Registration

Existing informal sector entrepreneurship is seen as a temporary phase. Policymakers should make it legal and attractive rather than just allowing it. This can be achieved by removing initial requirements associated with formal registration. The need to register could be gradually imposed above certain revenue thresholds.

It would also be beneficial for local communities to have a greater role in the registration and taxation of new and small businesses. For instance, if an ethnic minority group in a specific area is provided with the necessary authority to define conditions for registration, then the income generated from it should remain within that community.

Excessive regulations and bureaucratic requirements must be eliminated. Policymakers need to consider how much trust people have in government administration at local or central levels. This will incentivise people to formalise their activities because local communities are often trusted more than the central government, which is often seen as remote. Since trust is missing, the regulations imposed centrally are less likely to be followed.

### **Improve tax systems design**

Unintended consequences may encourage individuals and companies to remain in the informal sector. Simple tax codes with low rates and a low payroll tax can help. It's critical to establish supportive social protection systems that include progressive income taxes and protection for those in the most vulnerable positions. This will address issues of distribution and at the same time create incentives for self-support through entrepreneurship. Entitlements would not be lost at low levels of entrepreneurial income and would be reduced gradually as income rises.

Allowing tax breaks until sometime after registration would also help and ensuring limits are individual- or household-specific could mitigate opportunism such as repeated registration. Innovation will be supported through experimentation if an initial informal stage is allowed.

### **Improve equality and inclusion in structural policies**

To support sustainable development, various structural policies require investment in education equality, financial inclusion, labour market and technology policies. The goal is to increase returns, incentives, and decrease costs. We suggest reforms in the following areas:

- Education. Prioritise equal access to education and encourage the population to complete at least technical and vocational training.
- Financial inclusion. Enhance minorities' access to formal financial services to reduce informality and increase growth expectations for firms and entrepreneurs.
- Labour market inclusion. Simplify and make it easier for informal workers to enter the formal job sector, creating a more flexible and inclusive workforce.

- Technological inclusion. Use digital platforms and open innovation, including government-to-person mobile transfers. This empowers minorities financially, help new enterprises grow and possibly generate synergies with financial inclusion.
- Crisis management policy design. As the experience of the COVID-19 pandemic demonstrated, a rapid yet well-designed response to crisis is important for businesses and for creating incentives to stay formal. We need planning to anticipate potential new crises and design response.

## Change through practice

The government needs not be the only agent of change. Socially oriented entrepreneurs such as Gianinna Osorio play an important role. They engage in critical knowledge transfers by making information more accessible, helping decentralise financial education. Efforts like Gianinna's are critical to enhance the chance of survival, scaling-up, and formalisation of entrepreneurs with disadvantageous backgrounds.

A gradual shift towards increased formality or a reduction in informality of new firms over time will contribute to sustainable, dynamic and competitive growth for firms and countries alike.

Consequently, this shift also fosters inclusion and equality. The government, private actors and entrepreneurs with social motivation can contribute to this outcome.

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- This blog post is an edited version of an article in LSE's Department of Management [website](#). It is based on [A framework for investigating new firm entry: The \(limited\) overlap between informal-formal and necessity-opportunity entrepreneurship](#), in the *Journal of Business Venturing*.
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