About Business Environment Reform Facility (BERF)

BERF is funded by the UK Department for International Development (DFID) under the Business Environment for Economic Development (BEED) Programme. BERF is a central facility responding to demand from the DFID’s priority Country Offices and stakeholders to initiate, improve and scale up business environment reform programmes. BERF is managed by a consortium led by KPMG LLP. The programme started in January 2016 and will finish in January 2019.

We provide expert advice, analysis of lessons learned, policy research about what works and what doesn’t and develop innovative new approaches to involving businesses and consumers in investment climate reform.

BERF has a strong emphasis on strengthening the Business Environment for women and girls, as well as for young adults more generally. It is also aiming to improve the relationship between business and the physical environment including where relevant through linkage to climate change analysis. BERF recognises the need for appropriate political economy analysis in order to underpin business environment reform processes and interventions.

About this Report

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The views contained in this report are those of the authors and do not necessarily represent the views of KPMG LLP, any other BERF consortium member or DFID.
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1. Introduction

This scoping study reviews the range of evidence available on how business environment reform (BER) can support the formalisation of smallholder agriculture in developing countries, and specifically in the Department for International Development (DFID) priority countries. The results of the scoping exercise will be used to guide a more detailed review to fill the gaps in the evidence in this field. This work will help DFID’s Growth and Resilience Department to develop the strategic case for a programme to support the commercialisation of smallholder agriculture in some of DFID’s Priority Countries.

The World Bank’s Independent Evaluation Group (IEG 2015) notes that agriculture is the most important sector in the majority of developing countries. Thus, identifying and removing industry-specific barriers that hinder competition, and improving the regulatory and institutional framework for accessing finance in agriculture are considered important.

The smallholder agriculture sub-sector is typically informal, as is much of the service sector (such as transport, distribution, wholesale, retail and finance) around it. This exposes those working in the subsector to poor working conditions, exploitation and corruption (International Labour Conference, ILC 2002). It also limits the opportunities for smallholder farmers and agribusinesses to integrate into higher-value supply chains or access finance and also reduces tax revenues for the government.

This scoping study, and further research outlined in Next Steps (Section 5.7), will help DFID to understand the evidence about the impact of formalisation in different contexts, and to determine whether a phased or partial approach to formalisation can be developed to suit the individual contexts.

The study is not intended to be an exhaustive literature review, but rather provides a preliminary view on the state of evidence in this area. Its aim is to identify avenues for further study and how it should be approached (e.g., primary research or desk based secondary review of existing evidence).

1.1 Business Environment

The Donor Committee for Enterprise Development (DCED 2008) defines the ‘business environment’ as a: ‘complex of policy, legal, institutional, and regulatory conditions that govern business activities. It is a sub-set of the investment climate and includes the administration and enforcement mechanisms established to implement government policy, as well as the institutional arrangements that influence the way key actors operate (e.g., government agencies, regulatory authorities and business membership organisations, civil society organisations, trade unions, etc.).’
For the purpose of this scoping exercise, we adopt the DCED definition outlined above, while recognising that some authors may refer to the broader investment climate definition when describing some or all of these elements.

1.2 Business environment reform

DCED (2005) recognises a number of functional areas of BER that donor and development agencies have typically focused on. While BER can focus on general business environment issues, most reforms are concentrated on one or more of the following:

- Simplifying business registration and licensing procedures;
- Improving tax policies and administration;
- Improving labour laws and administration;
- Improving the overall quality of regulatory governance;
- Improving land titles, registers and administration;
- Simplifying and speeding up access to commercial courts and to alternative dispute resolution mechanisms;
- Broadening public-private dialogue processes with a particular focus on including informal operators, especially women;
- Improving access to market information; and
- Enabling better access to finance.

1.3 Informality

There has been a substantial shift in the way the informal sector is understood since the term was first coined in 1972 (see International Labour Organization, ILO 1972). The term ‘informal sector’ was used to describe the activities of poor working women and men who were not recognised, recorded, protected or regulated by the public authorities.

In 2002, the ILC discussed this topic at length and adopted the more encompassing and descriptive term of ‘informal economy’ to refer to all economic activities (i.e., not just ‘economic units’) that are not covered, or are insufficiently covered, by formal arrangements, either in law or in practice. Informal economic activities operate outside the formal reach of the law or where the law is not applied or enforced, or where the law discourages compliance because it is inappropriate, burdensome, or imposes excessive costs.¹

This description of the informal sector has multiple dimensions and means there is no single test which can categorise all enterprises as either formal or informal. There is no point at which an enterprise makes a binary transition from the informal to the informal sector. Indeed, DCED

¹ The ILO definition of the informal sector includes only non-agricultural activities, although for this scoping study we do not adopt this criteria and treat agricultural and non-agricultural sectors equivalently.
(2011) highlights the problem of defining informality and describes how ‘various degrees of informality can be found along a continuum between an enterprise operating completely informally to one that complies with all laws and regulations’.

According to the ILO, the informal economy accounts for 50% to 75% of all non-agricultural employment in developing countries.

1.4 Motivations for facilitating formalisation through BER

Donors and development organisations cast the informal sector in differing light. It is positively seen as the sector providing employment for many of the poorest people in developing countries, and where most micro-entrepreneurs make their living.

At the same time, those working in the informal sector have little security or protection. The ILC (2002) stressed that reforms should bring ‘marginalised workers and economic units into the economic and social mainstream, thereby reducing their vulnerability and exclusion’. For national governments, a large informal sector limits tax revenues and social security receipts (OECD 2004), although extending the tax net to the end of the spectrum and capturing smallholder farmers and microenterprises may incur more costs of collection than revenues generated.

The implicit theory of change that this study aims to test is a two-step chain of causality, from BER to improved incomes for smallholder farmers and agribusinesses:

- First, BER can encourage smallholder farmers and small and medium-sized agribusinesses to enter the formal sector.

- Second, increasing formalisation benefits smallholder farmers and agri-businesses.

Some BER interventions, however, will encourage formalisation by improving the incentives to register. For example, a reform of tax policy which reduces the tax burden on firms, and therefore the costs of formalisation, may encourage more smallholders to register as formal enterprises. Formalisation should not be seen as an end in itself. Rather, it is a means to improve outcomes, such as higher incomes, improved income security, reduced vulnerability, and higher tax revenues.

Finally, just as there are advantages to formalising both for the enterprise and the broader economy, there are also perceived disadvantages to remaining informal. The business owner’s decision to formalise can be influenced by both the perceived negative consequences of remaining informal and the advantages of becoming formal.

While informality may be seen in negative terms (such as a lack of security and high levels of harassment), it also carries certain advantages (in particular, low costs of doing business). The decision to formalise may increase incomes and market opportunities, but is also likely to increase costs and cash outflow. In some cases, evidence has been found showing that, even when incentives are offered and the cost of registration is significantly reduced, the transition
to formality is not straightforward. Improving enforcement mechanisms to make operating informally harder may be as important as simplifying the path to formality.

1.5 Objectives

The objectives of this scoping study are to:

- Produce a preliminary assessment, evidence review and synthesis of the impact of formalisation on smallholder farmers and agribusinesses.
- To understand the possible impact of BER on formalisation, and whether there is evidence on which types of BER have the biggest (i.e., fastest or most widespread) impact on smallholder farmers who are formalising through their engagement with commercial agribusinesses.
- Identify gaps in the evidence and propose a programme of research to better understand the impact of formalisation on the smallholder agricultural and agribusiness sectors in different contexts, such as different physical, business, economic, political or social environments, and the possible options for the sequencing of formalisation efforts.

1.6 Scope

This scoping study seeks to identify what evidence can be drawn on to answer the following questions:

- What is the evidence on the impact of formalisation on the smallholder and micro, small and medium agribusiness subsectors?
- Does the impact vary given the local context (in terms of physical, business, economic, political or cultural environment) and how well is this understood?
- Does the evidence distinguish between graduated and all-at-once approaches (i.e. between fully formalised and staged partial formalisation for particular contexts)?
- What is the current evidence supporting claims to BER facilitating formalisation in the smallholder and micro, small and medium agribusiness sub-sectors?
- What can the evidence tell us about the optimum sequencing of BER on formalisation in order to reduce disincentives and optimise benefits?
2. Informality in the rural economy

Research confirms that there is no clear line separating informal and formal firms. The transition from informality to formality is not binary. Informality can range from survivalist, livelihood-based enterprises to growth-oriented enterprises, and even to medium-sized firms operating below the tax radar. Firms which are more formal have different characteristics from those which are more informal. These are discussed in the context of smallholder agriculture and agribusinesses.

We have adapted the DCED’s ‘functional areas’ of the business environment, and developed a set of dimensions of formality for smallholder farms and agri-businesses in the rural economy. These dimensions are based on our review of the literature and DFID programme documents. We use this framework to organise our findings throughout the rest of this paper.

The dimensions considered throughout this report are:

- **Formalisation of land titles**: Many smallholder farmers do not have formal legal rights to their land, and the formal legal system may operate in parallel to customary law and informal land rights. Several DFID supported rural development programmes include a focus on formalisation of land titles (including in Nigeria, Tanzania and Rwanda). Securing access to land rights is often assumed to facilitate access to credit (i.e. where land is used as collateral) and incentivises investment.

- **Access to formal credit**: The International Fund for Agricultural Development (IFAD) emphasises the lack of access to formal financial services and credit facilities faced by many rural, agricultural communities. This gap in the market is often compensated with informal lending by friends, family or purchasers. Partial formalisation may include development of community savings groups. Business registration and record keeping may facilitate access to credit; land titling (collateral) and formal contracts, although if it opens up investment opportunities direction of causality may be two way.

- **Contracting**: Rural agriculture is often conducted through informal agreements between buyers and sellers and at market places. Quality and hygiene standards may be variable, and traceability limited, which prevents smallholder farmers from taking advantage of value chains. Formal contracts may provide security regarding prices, embed quality standards and encourage investment.

- **Business registration**: While formal business registration is not an end in itself, evidence from other sectors suggests it may encourage growth by integrating into more advanced value chains and providing access to credit. However, it can also bring with it administrative burdens disproportionate to the benefits (e.g. in Pakistan). Business registration often includes tax registration (e.g. creation of a tax identification number). In many cases, this has negative impacts because informal firms are cautious of the implications this will have on their future revenues and costs.
Formalisation of labour relations: Most agricultural work will be seasonal and workers often casual and informal. This is a cause for concern for many donor and development agencies, although the sheer abundance of this form of labour suggests there is no quick fix and that there are implications for businesses of increasing labour market rigidities. The International Finance Corporation (IFC) advocates for cooperatives of informal workers in other sectors (e.g. domestic house-workers).

The dimensions of formality, with examples that characterise more or less formal enterprises, are set out in the figure below.

**Figure 1 - The dimensions of formality in the agricultural sector**
3. The impact of BER reforms and formalisation

3.1 Introduction

Since the term informal sector was coined in the early 1970s, this field has been a rich subject for investigation. In the last 10 to 15 years, more attention has been given to the link between poor business environments and informality. However, only in more recent times has attention been turned to BER support programmes and their effect on enterprise formality. Within this narrower scope of evidence, there are very few research findings specifically focused on smallholder agriculture.

As discussed in the introduction, there are two logical steps underpinning BER that explicitly aim to facilitate formalisation: that the reforms will encourage formalisation and that formalisation is beneficial. We consider the evidence on the benefits of formalisation first, before turning to reforms which encourage formalisation.

3.2 The benefits of formalisation

Encouraging firms to formalise is widely expected to benefit both the enterprise and the broader economy.

At the enterprise level, formalisation is encouraged in order to help firms improve access to the inputs they require (e.g. improved access to financial services) as well as to larger markets (e.g. through more formal commercial contracting). In addition, the quality of employment in these firms will be improved (e.g. increasing use of employment contracts and social protection scheme, award wages), as will the productivity of workers (e.g. through improved working conditions, investment in staff training). The net result of this transition over time is improved firm productivity and increasing revenues.

At the economy level, the formalisation of the informal sector increases competition (e.g. new formal market entrants), private investment (e.g. firms invest in new plant, equipment, staff, and staff training), and government revenue (e.g. increases in number of tax payers and size of tax payments). The net result of this transition is improvement in the competitiveness of the economy and the capacity of the government to provide services, leading to economic growth and a decline in poverty.

De Soto championed work on the economic and legal empowerment perspective on informality, along with the Commission on Legal Empowerment of the Poor (2005). This promotes a rights-based approach to dealing with poverty and the informal economy in general. These rights can be classified into four ‘pillars of legal empowerment of the poor’:

- Access to a well-functioning justice system;
- Effective property rights to tap the intrinsic economic power of their property;
- Safe working conditions for workers (and for women and children in particular) when their employers operate outside the formal legal system; and
Access to economic opportunities (e.g. credit, investment, international and domestic markets) as their property and businesses are not legally recognised.

The informal sector is largely characterised by a lack of these rights, which creates impediments to empowerment of the poor. In this respect, formalisation may be viewed as an end in itself.

Zinnes (2009) argues that formalisation can bolster policy reforms. For example, high levels of informality can undermine public-private dialogue efforts and weaken institutions. Culturally and historically driven informality can lead to self-regulation and make informal actors resistant to reforms.

Evidence suggests that only a few firms transition into formality having started as informal businesses: according to La Porta and Shleifer (2008), on average, only nine per cent of formal firms started out as unregistered. La Porta and Shleifer (2014) argue that informal firms have a tendency to remain informal. They do not use the formal banking system to pay for labour and goods, generally use little capital and add little value. The authors suggest that ‘the increase in firm value that the informal entrepreneurs or managers could realise by operating formally is too small to offset the additional costs from taxes and regulations.’

The benefits of different dimensions of formality are discussed in Section 4.

### Box 1: The gender impacts of formalisation

The benefits of formalisation may be greater for women than for men. Chen et al. (2011) study the impact of the investment climate on female owned, informal businesses in Gujarat, India. They find that the constraints faced by these businesses are greater than those faced by male run informal businesses (both faced greater constraints than the formal sector). These constraints include access to technology, finance, storage, irrigation and transport infrastructure. In particular, high costs of inputs, the seasonal nature of the sector and the lack of formal credit create a ‘cycle of debt’. Zinnes (2009) argues for support for the formation and strengthening of women’s associations, along with technical assistance and competitively allocated grants to women’s entrepreneur associations.

### 3.3 The impact of business environment reforms on formalisation

Perhaps the most famous of studies on informality and the business environment were published in 1989 by Hernando De Soto. Based on his analysis of urban slums in Peru, and subsequently other countries, De Soto (1989) argued that informal firms aspire to become formal, but are held back by corruption and poor government regulation.

In more recent years, evidence has been produced to provide a more detailed understanding of the ways in which business environment influences informality and the decisions of informal business owners and managers to formalise. Indeed, the De Soto argument is often considered oversimplified.

Business environment reforms can encourage formalisation through a number of mechanisms, but for them to have a lasting impact they must stimulate investment by the poor (Zinnes 2009). They can incentivise voluntary formalisation by increasing the benefits, such
as providing access to credit to registered enterprises, or reducing the disincentives (e.g. the lowering the tax rate on registered firms). BER can also make the transition to the formal sector easier (e.g. by simplifying business and tax registration procedures). Finally, it can discourage informal sector activity (e.g. through fines on unregistered businesses).

Several authors note that the quality of the business environment and the wider investment climate is likely to encourage formalisation. In particular, tax policy is seen as affecting the relative costs of operating formally. This plays an important role in determining whether resources head towards the informal or formal sector (see Kar 2016, Zinnes 2009, Klapper et al. 2009) in cross country studies. Similarly, in his analysis of enterprise data in Uganda, Mawejje (2013) finds that tax registration and payment is influenced by the effectiveness of the court system, the presence of bureaucratic bribery, insufficient provision of complementary public capital, such as electricity and transport infrastructure, as well as an adverse business environment.

Zinnes (2009) and Klapper, et al. (2009) review the literature and find links between business registration and stable political climates, good governance, low burden labour and tax policies, and the quality of energy, product, financial and capital markets. Zinnes advocates the strengthening of the pillars of legal empowerment discussed above. Kar (2016) argues that tax policy, by capital mobility and the interactions between trade and labour market reforms and policies determine the impact on informal sector employment.

The availability of information or assistance with formalisation is not always enough to incentivise formalisation. De Andrade et al. (2013) conducted a field experiment in Brazil, having assigned firms to either a control group or a treatment group where the firm: (1) received information about the processes of formalisation; (2) the same information, free registration and the services of an accountant for a year; (3) visits from inspectors; and (4) firms not receiving visits from inspectors but in close proximity to those which were. The only group that had increased registrations was the one that received inspections themselves, which led authors such as La Porta and Shleifer (2014) to infer that ‘most informal firms do not formalise unless forced to do so.’ Similarly, de Mel et al. conclude that the ‘majority of own account workers are unlikely to grow’.

They conclude that, whilst simplification of business registration advocated by De Soto (1989) is probably a positive step, it is unlikely to have large impacts on the number of firms registering. Conversely, penalising the informal sector through taxes and regulation is more likely to encourage firms towards formalisation, but may have severe negative repercussions for informal sector incomes and the livelihoods of the poorest in society. Policies should recognise the inefficiency of informal firms and avoid imposing any kind of additional costs.

3.4 Formalisation in the agricultural sector

Despite the high levels of informality in rural and agricultural economies, there is little evidence concerning how BER has influenced the decisions of smallholder farmers and agribusinesses
to formalise. Most studies on formality are at the general or macro level or were located in urban contexts or focus on non-farm households. Only a small number explicitly consider the agricultural sector.

On the other hand, there are increasing efforts to work with informal agricultural firms and workers operating in the informal sector to advocate for rights, and to increase their capacity to compete and grow. Typically, these efforts focus on specific sectors, sub-sectors or value chains. For example, Women in Informal Employment: Globalising and Organizing (WIEGO) has a long history of working with informal workers in urban and home-based settings, but has also undertaken research into the formalisation of agriculture value chains. However, this often focuses more on worker rights, than the productivity or formalisation of firms. Sidai Africa is a social enterprise operating in the livestock sector in Kenya, which aims to improve the provision of livestock and veterinary services to pastoralists and farmers by creating a more sustainable service delivery model. The African Fertiliser and Agribusiness Partnership is also an example of an organisation intervening in agriculture value chains by supporting public-private partnerships in the production and distribution of fertiliser, and supporting the markets in which agro-dealers operate. While these organisations work with informal agribusinesses, they do not engage in extensive BER activities. Where they do, the evidence of the effect of these efforts on national or sector business environments is unclear, and their impact untested.

The dearth of evidence of the impact of formalisation in the agricultural sector is not surprising. The informal agricultural sector includes many subsistence farmers that would be unlikely to consider themselves entrepreneurs or their work a job. The perception that farming is not a business is evident in Bosnia and Herzegovina, where farmers resisted formalisation despite the tax benefits of doing so. This is discussed in Section 4.4, below. This suggests that low levels of human capital (or cultural resistance) in the sector may prevent an appreciation of the benefits of formalisation, but other evidence suggests that it may also curtail the aspiration and the ability to grow (see de Mel et al. 2008, La Porta and Shleifer 2014). This is an important distinction between smallholder farmers and the urban entrepreneurs De Soto studied.

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2 For example, the ILO (2015) policy guidance notes on *Transitioning to Formality in the Rural Informal Economy* do not cite empirical evidence on the topic.


4 Sidai Africa: http://www.sidai.com

5 African Fertiliser and Agribusiness Partnership: http://www.afap-partnership.org
Zinnes (2009) describes the literature’s broad categorisation of the significant regional diversity in the extent and characteristics of the informal economy. He provides the following regional distinctions.

• In Sub-Saharan Africa (SSA), ‘a profound lack of skills, credit, and infrastructure is probably more the problem than weaknesses in the business environment’.

• In Latin America and the Caribbean informality is driven by lack of title to assets, especially land, and the ability to acquire financing for commercial activities.

• In Asia, informality is more institutionalised than in SSA and the poor work environment for children and women is especially problematic in South Asia.

• In the transition economies of Central and Eastern Europe and the Former Soviet Union, the informal economy is mainly about avoiding taxation, regulation and corruption.

It is unclear whether this categorisation can be applied to all analysis, but this framing of the informal economy does appear to help in bolstering the need for a sound understanding of the causality of informality. Informality is the result of a range of economic, social, political and legal factors, many of which are unique to a specific region, local environment and sector. The role of BER and of other donor and development agency interventions should be based on a sound analysis of these factors.
4. The dimensions of formality

4.1 Land titles

Property rights, and especially land rights, are an important issue affecting the formalisation of rural firms, including smallholder farmers and small agribusinesses. The United States Agency for International Development (USAID 2014) argues that property rights increase the likelihood of farmers making longer term investments in their land, increase access to credit so landholders can more easily finance on-farm investments, enable land transfers through more dynamic land markets, and make it more likely to attract the further investment necessary for broad-based economic growth. DFID (2014) found ‘a medium-sized body of high-quality evidence supporting an association between secure property rights and long-term economic growth. In the most part, the focus of these reforms is on formalising land titles and improving the registration and administration systems. However, there is a substantial debate regarding the extent to which these issues improve firm performance.

4.1.1 The impact of property rights on investment

There have been many theoretical and macro-level studies that present the relationship between improved property rights, economic growth and poverty reduction. Authors such as De Soto (2000) have long argued that household property rights and formal land titles have a significant impact on capital formation and poverty. Kerekes and Williamson (2008) empirically tested De Soto’s hypothesis using macro-level cross-country regressions and found positive and significant effects of property rights institutions on wealth, collateral and capital formation. Acemoglu et al (2001) have shown the importance of property rights and good institutions, while Acemoglu and Johnson (2005) find that good ‘property rights institutions’ have a ‘first-order effect on long-run economic growth, investment, and financial development’.

Smith et al (2007) found the detrimental effects of informal land tenures, including disputes, lower land values and difficulties using it as collateral, particularly affect poor households in Ethiopia, Vietnam and Uganda. In Ethiopia, Kebede (2002) examined 15 village case studies and concluded that low investments in irrigation systems and modern equipment were symptomatic of insecure tenure with common pool resources ‘in a state of either exhaustion or stress’. Subsequently, also in Ethiopia, Deininger et al (2011) used household panel survey data to show that land certification in Ethiopia led to benefits through increased land-related investment, which were greater than the costs of implementation.

However, not all agree that formalisation is the solution. Bromley (2009) provides a secondary analysis of the literature and concludes that poor people are poor because of a broader set of ‘flawed economic policies’. He argues there is very little empirical evidence linking the formalisation of land titles to poverty reduction, and that land tenure reform should not be elevated above other policy reform priorities. Payne et al (2009) and Cousins et al (2005) support this view.
Stein et al (2016) find little evidence to support the view, taken by a ‘multiplicity of actors at great expense to donors, individuals and the government of Tanzania’, that farmers can use land reform to access the formal banking sector. Zinnes (2009) agrees with this position, arguing that farmers would not risk their single most important asset by using it as collateral.

4.1.2 Land titling programmes

Several of DFID’s recent and on-going programmes involve the formalisation of land titles. These include the Rwanda Land Tenure Regularisation Programme; the Land and Livelihood Rights for Pastoralists in Tanzania, and the Growth and Employment in the States (GEMS) programme in Nigeria.

Pritchard (2013) examined mandatory land registration in Rwanda and found mixed results. He noted that the government had avoided fears that the fees would exclude the poorest households, and that ‘the low cost of registration has significantly increased access to privately held and guaranteed lands’. Less positively, he concluded that forced registration had been coupled with mandatory crop specialisation, so that ‘no input into when and how, let alone what crops are planted, land holders are essentially being transformed into agricultural labourers’.

Odhiambo (2015) undertakes a review of land policies and their implications for smallholder agriculture in six African countries (i.e. Tanzania, Uganda, Ghana, Mali, Mozambique and Zambia). As with other dimensional interventions, titling was usually one component of a programme aimed at improving agricultural productivity through better technology, infrastructure and markets. The author notes that where land titling was a central feature, as in Tanzania and Mali, it was with the objective of increasing foreign direct investment. He found that smallholder farmers were generally not represented in the policy formulation process, and recommended the Alliance for a Green Revolution in Africa (AGRA) should place more emphasis on supporting representative groups.

Lennart Båge, the previous President of IFAD, noted in an interview that efforts to empower rural people through tenure security did not always capture the full range of rights implicit within customary law. Mechanisms used to formalise land rights can be subject to political capture.

4.2 Access to credit

One of the most often cited constraints which smallholder farmers and rural agribusinesses face is a lack of access to credit to invest in productivity enhancing technologies (see Danielson 2002, IFAD 2010, Salami et al 2010, and IFC 2013). Formal financial services are typically not available in rural settings because the dispersed population and high informality contribute to high transaction costs (IFAD and AfDB 2010).
Disputing this view, however, de Mel et al (2008), studying informality in Sri Lanka, find lack of growth is largely derived from a lack of ability or desire of informal operators to grow, rather than a lack of finance.

Formalisation may assist in two respects. The extension of formal financial services to the rural economy may improve the availability, affordability and quality of credit to farms and agribusiness. Meanwhile, business formalisation in other dimensions, particularly registration, contracting and land titles, can provide the track record and collateral which banks require in order to offer credit products to businesses.

La Porta and Shleifer (2014) argue that the link between access to finance and registration may not be causal. They suggest the lack of human capital might be at the heart of the perceived inaccessibility of finance and other barriers.

Land titles are often assumed to be a catalyst for improved access to credit by providing collateral, although authors such as Zinnes (2009) argue that even when in possession of titles and registered property, small-scale farmers ‘do not put their land or modest dwellings at risk by using them as collateral for credit: collateral requirements are too high and too little risk is shared by the financial intermediary’.

Kanji (2015) recommends introducing policy incentives to encourage financial institutions to develop profitable initiatives that promote the formalisation of their informal clients. This includes the use of formal bank accounts to ensure informal enterprises and their workers are a part of the formal banking system.

DFID currently has a number of programmes which aim to improve access to credit for smallholder farmers, which include more formal lending arrangements. The Livelihoods and Food Security Trust Fund for Burma (LIFT) programme aims to expand financial services for rural households, small businesses and micro-enterprises through micro-finance institutions and banks. Surveys showed that supported households saw increases in income of 25% versus the previous year, against 16% increase in control group, however the results did not untangle the impact of improving access to finance from value chain strengthening through improved technologies and production techniques. Similarly, the PrOpCom programme in Nigeria resulted in significantly increased incomes but included both access to financial services through mobile banking together with agricultural mechanisation and fertiliser supply.

Both the LIFT programme in Burma and the Bihar Agriculture Growth and Reform Initiative in India highlight the importance of seasonal finance for farmers.

However, the business case for the Livelihood Enhancement Through Agricultural Development (LEAD) Programme in Tanzania states that there is only ‘some’ evidence that, given improved access to finance, farmers are willing to invest in higher quality inputs, and that there is only ‘weak’ evidence that these investments are prioritised over other types of expenditure, such as pressing household expenditure.
The Pro Poor Growth Programme in Zimbabwe noted that most of the evidence on the growth impact of improved access to credit for micro-entrepreneurs (e.g. through microfinance initiatives) is anecdotal. As a result, it is hard to draw general conclusions. However, a longitudinal study of 25 micro-finance institutions in India showed that 75% of beneficiaries increased incomes by over 69%, compared to just 31% of the control groups (Agricultural Finance Corporation Limited 2008). This study concluded that ‘all but its most ardent critics agree that microfinance is pro poor,’ because it enables more choices over household consumption patterns.

4.3 Contracting and dispute resolution

4.3.1 Contract farming

Establishing formal contracts with suppliers and customers, including contract farming, can provide smallholder farmers with better income security and encourage further investment in land. The ability to enter into and fulfil such contracts is essential for smallholders wishing to access higher value marketing chains, such as supermarkets, who also require consistency, uniform quality, high standards of hygiene and traceability of supply (Hazell 2005, Salami et al. 2010).

These findings are supported by primary research. Gou et al (2007) surveyed farmers in China and find households perceive contract farming as offering price stability and better market access, with purchasing firms seeing contracts as a means to secure more stable and higher quality supply.

Minten et al (2009) surveyed contract farmers in Madagascar and found that contracts improved welfare by reducing the ‘lean period’. They also found evidence of greater use of composting, although this was likely a result of knowledge sharing through the contracting process rather than a greater incentive to invest due to price stability.6 Salami et al (2010) provide anecdotal evidence from Uganda that contract farming has contributed to more stable and predictable incomes.

4.3.2 Dispute resolution

Informal enterprises do not typically have access to the formal commercial court system, which, according to Zinnes (2009) limits their dealings to parties with whom they have personal or social ties. While these arrangements allow the parties to make use of informal dispute resolution processes and traditional means of justice, they can be locked out of formal dispute resolution mechanism and the commercial courts. Policy reforms in this field typically focus on improving access to formal dispute resolution channels, strengthening and improving the quality of customary and traditional governance methods, improving linkages between (and

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6 Farmers reported that they would continue using compost even if the contract were removed, and also increased use of compost on non-contractual farm use.
greater awareness of) formal and informal systems of justice, and improving access to justice in bureaucratic administration (DCED 2011).

The Commission on Legal Empowerment of the Poor (2008) recommends the improvement of identity registration systems, without user fees, and the strengthening of legal aid systems with expanded legal service specialists. Again, much of this is normative. There is very little clear evidence on the impact of BER in this domain, especially with regard to formalisation of smallholder farmers.

4.4 Business registration

Perhaps the most commonly thought of dimension of formalisation is business registration. If any dimension were to include a binary transition from the informal to the formal sector, it is likely to be the point where a business is registered as a legal entity. Even so, there are various forms of registration (e.g. as a legal entity, registered for tax purposes, opening a bank account), production and trading licences, which blurs the line.

4.4.1 Benefits of registering a business

Deininger et al (2007) surveyed rural non-farm enterprises and households in Sri Lanka. Although regulatory constraints were not mentioned as a key concern by existing enterprises, they found the ‘time needed to complete company registration, the only variable which one would expect to affect start-ups differently from existing enterprises’, was indeed ‘significant and negative’. They estimated that reducing the registration process from 19 days to four days would increase ‘the probability for an average rural household to start-up a new enterprise’ by 1.5%.

Vermeulen and Cotula (2010) surveyed various business models that can provide opportunities for smallholders. They pointed to evidence from Boyd (2005) which showed that taxes and licence fees were low for cooperatives but that legal recognition could afford access to support mechanisms such as export guarantee schemes. They concluded there was ‘tremendous scope for scaling up these types of business’.

4.4.2 Encouraging more business registration

The simplification of business registration and licensing procedures is a key reform strategy designed to support the ‘formalisation’ of firms, reducing the costs and burdens of starting and doing business. However, the evidence from Brazil, discussed in Section 3.3, above, shows that reducing the costs of registration was not enough, but that only a ‘stick’ approach of inspections encouraged firms to register.

Cross country evidence (Klapper et al 2009) and evidence from Uganda (Mawejje 2013), presented in Section 4.4.2, suggested that countries tend to have higher levels of business registration and tax payment when there is a more generally competitive investment climate.
4.4.3 Tax registration

Taxes on registered firms create one of the biggest disincentives to formalise. Forthcoming Business Environment Reform Facility (BERF) survey work in Pakistan shows that the complexity of the tax system is the biggest concern of registered businesses, and has encouraged many small and medium companies to remain in the informal sector. Reducing the tax implications of registering a business may, therefore, encourage more firms to formalise.

There is strong and consistent evidence positively linking tax registration and payment with firm performance (e.g. Boly 2015, Fajnzylber et al 2009, and Kenyon and Kapaz 2005). Tax-related BER has been found to increase the number of firms registering for tax. The IFC (2013) argued that a streamlined tax system can increase the number of firms in the formal economy, facilitate investment, widen the tax base, and rationalise a company’s tax compliance cost. However, despite the recognised benefits of formalisation, many firms choose to operate informally in order to avoid the perceived burdens and costs associated with formality.

In 1996, Brazil introduced a business tax reduction and simplification scheme, known as ‘SIMPLES’, for micro and small firms. This allowed small, labour intensive firms to pay a fixed and relatively low percentage of total revenues instead of payroll tax which resulted in lower labour costs and a strong incentive to hire new employees and legalise existing labour relationships. Fajnzylber and Montes-Rojas (2011) found this reduced the tax burden on small, eligible firms by about eight per cent and changed firm behaviour: more firms registered for tax and formalised so as to benefit from the reform. Both the existing and newly created firms that opted to operate in the formal sector had higher revenues and profits, and employed more workers. However, the research could not distinguish between the impacts of lower registration costs and reduced overall taxes and number of payments.

Christoplos (2007) described how market entry into the EU poses challenges for informal smallholder farmers in Bosnia Herzegovina, describing agriculture’s status as a ‘grey area of the economy’ from an EU integration perspective, since support to the sector was tied to strict and complicated rules for procedures and payments. Within this setting, farmers had to be registered in order to benefit from EU market opportunities. Thus, Bosnia Herzegovina introduced a system of value added tax (VAT) which was partially intended as an incentive for informal enterprises, including farms, to register as businesses in order to be able to reclaim the VAT for their input costs. To date, this measure has made conditions particularly hard for micro-farmers, who are very unlikely to register their farms as businesses. They are sceptical about the value of keeping strict accounting records on their ‘hobby,’ and fear that such bookkeeping is more likely to open the door to increased taxes, rather than rebates.

4.4.4 A graduated approach

The ILO sees cooperatives as an important halfway house in the transition from the informal and formal sector, noting that the capital requirements tend to be minimal, and that legal
recognition provides access to tax regimes. The cooperative model is considered particularly relevant to the agricultural sector, and the ILO presents evidence of it being effectively used in Rwanda, where a concerted effort has been made to support cooperative formation in the agricultural sector that has included a number of laws providing cooperatives with regulations, registration and conflict settlement.

4.5 Labour regulations

Improving incomes, job security and working conditions are often explicit objectives of formalisation. The ILO notes that, whilst it is hard to draw generalisation, the informal sector ‘most often means poor employment conditions and is associated with increasing poverty.’

The ILC adopted Recommendation 204, to guide members in their efforts to facilitate the transition of workers from the informal to the formal sector and prevent the informalisation of jobs. It sees reducing the vulnerability and exclusion of marginalised workers as the main policy objective in addressing the informal economy.


The evidence on labour laws and administration is thin with few practical conclusions, and evidence on labour laws in relation to smallholder farming and agribusiness is absent from the literature we reviewed.

Chen (2007) argues that policies aiming to increase labour market flexibility to support businesses and increase formal sector employment are running against limited labour mobility, retarding the uptake of new opportunities. He argues for the re-regulation of labour markets to protect informal workers from the economic risks and uncertainty associated with these trends.

Several authors argue that labour policies discourage entry into the formal sector, although these tend to be based on reported perceptions of business rather than quantitative evidence. For example, Hampwaye and Jeppesen (2014) find labour laws, in particular the minimum wage regulation of 2012, are the main problem reported by the majority of food processing firms in the country. Similarly, BERF’s forthcoming study of Pakistan identifies labour inspections as the most costly (in time and bribes) aspect of formal sector regulations.

Besley and Burgess (2004) examined the relationship between regulation and development in India and found that ‘pro-worker’ labour reforms tended to reduce investment flows and act as a constraint to growth and poverty alleviation, whilst failing to translate to better employment

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outcomes for workers. Conversely, Berg and Cazes (2008) present evidence on a range of legal and institutional features, and find that employment protection legislation may have positive impacts on productivity because it encourages training and innovation at the firm level.

Outside of the agricultural sectors, both the IFC and IFAD suggest that the organisation of labour into unions or cooperatives can improve employment terms for those operating outside of the formal sector. In Bangladesh, IFAD has supported labour contracting societies (LCS) for infrastructure development, which have created employment opportunities for women, who account for 40% of LCS members and whose wages are set equivalent to their male counterparts (IFAD 2016). The ILO promotes employee cooperatives, particularly for domestic workers, and provide case studies across Jamaica, India and South Korea of these organisations engaging in policy dialogue around issues such as minimum wages, healthcare and social security (ILO 2014).
5. Conclusions

5.1 Assessment of the evidence

Overall, there are significant gaps in objective evidence on how BER influences formalisation among smallholder farmers and in agribusiness. There is a great deal of guidance and general advice on these areas, and broad agreement that the high levels of informality in this sector demand attention, but scant evidence on what BER has achieved. Most evidence comes from urban settings.

Many agricultural support programmes which DFID and other donors and multilateral development agencies support do not explicitly target formalisation, but undertake interventions which will facilitate the transition of smallholder farmers towards formality on one or more of the dimensions in our framework.

Much of the ‘evidence’ is based on logical assertions rather than primary scientific research or evaluations. In many areas, a better understanding of the constraints faced by smallholder farmers and agribusinesses is required. The primary evidence is thin in many areas and many programmes are designed based on the dogma that formalisation causes improved productivity and growth. In many cases, it appears that an enabling business environment is necessary, but not sufficient for stimulating growth. This applies to both reforms to the business environment and value chain interventions.

5.2 Supporting the informal sector

A formal sector growing crowding out the informal sector may be beneficial, provided a growing formal sector brings with it benefits such as higher productivity, improved incomes and better quality of jobs. However, the opposite may not be true. The implication of Chakrabarti’s (2014) argument is that support to the informal sector may be to the detriment of the formal sector, as productive resources (labour and capital) are redirected back to the informal sector. This could lead to the informalisation of jobs which the ILC’s Recommendation 204 seeks to avoid, and lost opportunities to increase tax revenues and provide more and better public services.

Nonetheless, IFAD's Rural Development Report (2016) argues that, given the size and importance of the informal sector in rural economies, it is important to consider the informal sector as a potential for growth and to work with it, rather than going against the grain:

This entails reducing administrative and land constraints, improving productivity and extending social protection to workers in the informal sector and to the growing number of informal workers used by firms operating in the formal sector. Informal sector entrepreneurs and workers should have assistance to function better, through legal protection against harassment, investment in skills and provision of well-sited land, electricity, water and sanitation.
Informality can impact the effectiveness of BER. In situations where there are high levels of informality, many BER programmes can appear irrelevant to informal operators. While evidence on this does not draw from the agriculture sector alone, it appears this issue is extremely relevant for smallholder farmers. Reforms that are not immediately relevant to smallholder farmers, and which they may not have been consulted on, may do little to affect their behaviour in terms of making a decision to formalise.

5.3 Sequencing of reforms

Few studies attempt to consider the sequencing of policy reforms to encourage formalisation. De Soto argues that simplifying business registration procedures should be a first step. This is relevant to the decision to formalise, but other factors will also come into play, including the tax and the regulatory burden. Evidence from Brazil and Bosnia and Herzegovina shows that simplifying business and tax registration procedures is insufficient, particularly for the agricultural sector, where the benefits of formalisation may be low and there may be cultural resistance. While tax registration reforms have led to improvements in firm level performance and produced economy-wide gains in terms of government revenues, many unregistered business owners and managers remain wary of the cost implications of registering with the tax authority.

Labour law does appear to have an impact on formalisation. Labour laws inappropriately favouring workers at the expense of employers can be a disincentive to expand by employing more workers. In addition, many workers in the agriculture sector are casualised and unprotected. Thus, reform in this field often focuses more on informal workers, which can include child labour, rather than formalisation of employers for the purpose of growth. Despite the huge scope for reforms in this field, it remains inadequately studied. Given the challenges already faced by the informal sector with low productivity, and its importance for incomes, measures that increase the burden of operating should be avoided. These include punitive measures but may also include efforts to tightly regulate labour arrangements.

Land is often seen as a first step, because it can encourage investment and facilitate access to finance. But the evidence on the impact is mixed, and interventions can be costly and politically difficult to manage.

Evidence from a variety of programmes shows that the business environment can have a major impact on whether value chain improvements will succeed. These can be particularly important in the agricultural sector, both because it is characterised by raw materials that are perishable and not available throughout the year, which presents a particular risk for investments, and because agriculture is often subject to public policy which addresses concerns around food security and food safety (da Silva and Mhlanga 2013).

Value chain upgrading is a common development intervention in the agricultural sector, providing an opportunity to assess the causes of sector informality and to design a programme response that combines with BER interventions. Access to finance, which can be configured
within supply chain support, is a common focus here. However, it is rare to see these programmes deal with broader access to finance and BER. Experience in these programmes has highlighted the roles large lead firms can play in driving market opportunities, which can create important incentives for informal smaller firms to formalise. Thus, market access and the desire to grow—and a path for growth—appear to be important ingredients in the decision making process in favour of formalisation.

An area that emerges from the literature across multiple dimensions is the role that cooperatives and business associations can play in facilitating the transition from the informal to the formal sector. Organising agricultural sector enterprises has been shown to facilitate access to credit, through community savings groups, and contracting into higher value chains. Organising labour has been shown in other sectors to lead to better working conditions and incomes, although evidence in the agricultural sector is limited.

5.4 Economic development and formalisation

Some of the literature suggests that the formal and informal sectors are in competition for resources. For example, Chakrabarti (2014) describes an ‘inherent conflict between the formal and informal sectors originating from the crucial condition of economic resource-sharing’. As the formal sector expands, ‘it squeezes the informal sector by dragging out resources’. Similarly, La Porta and Shleifer (2014) argue that expansion of the formal sector leads to the decline of the informal sector in relative and, eventually, absolute terms, although informal employment can remain high for a long time, especially with high growth in the labour force.

This suggests that the ultimate ‘cure’ for informality is to ensure prosperous growth of the formal sector, increasing the incentives for transitioning and reallocating resources towards it. As La Porta and Shleifer (2014) note, this process can be particularly slow if labour force growth is high. They argue that an important bottleneck to economic growth is not the supply of better-educated workers, but the supply of educated entrepreneurs—people who can run productive businesses. Similarly, Estudillo et al (2013) highlight the importance of creating lucrative non-farm jobs, either by improved wage rates in informal sectors or the transformation of the informal sector into the formal.

5.5 Informality in fragile and conflict affected states

This review of evidence has shown how context matters. For example, Zinnes (2009) describes the literature’s broad categorisation of the significant regional diversity in the extent and characteristics of the informal economy. Understanding this draws attention to the role of the informal sector in fragile and conflict affected states.

There are clear links between violence and conflict, and the nature of the private sector (see Mallett and Slater 2012). Private sector development has been recognised as an important instrument in responding to conflict and building trust (see Curtis et al 2010 and MacSweeney 2009). Yet, despite this, there is very little evidence on the role of BER in promoting the
formalisation of small and medium agribusinesses in conflict-affected states. As Schoofs (2015) says, ‘there are more questions than answers when it comes to the phenomenon of economic informality in fragile contexts’.

Schoofs (2015) argues that the established idea of formalising the informal economy needs to be carefully rethought in contexts where state capacity is severely diminished as a result of fragility and conflict. Development agencies should “steer clear of a reductionist view that perceives the informal economy solely in terms of economic (dis)-incentives for compliance with formal rules and cost-benefit decisions of informal operators”.

Doyle et al. (2016) recommend policymakers consider how informal markets fill a trust deficit in fragile environments before implementing formalisation policies. Interventions should be considered in instances when the conditions for formalisation are ‘ripe’ and, when formalization is determined to be the best option, changes should be phased in slowly. Each step towards formalisation, should involve communicating the benefits of formalisation to the informal business community.

5.6 Implications for business environment reforms

It is important to understand the systems that drive and sustain informality. There is a link between formal and informal agricultural sectors, and changes in one can affect the other. Moreover, there are country and sector specific factors that shape the size and nature of informality. The analysis of this will influence the design of interventions, including BER and value chain interventions.

Policy interventions need to carefully consider the intended and unintended consequences of BER on the informal sector. Most people in developing countries work in the informal sector, and especially in rural, agricultural economies. Informal firms tend to be unproductive and incomes in the sector are suppressed. Anything that increases costs for informal firms or firms graduating towards formality risks aggravating poverty. Policies designed to promote formality should be introduced with caution, especially where they are based on penalising informality (the stick approach) rather than increasing formal sector performance (the carrot approach).

Graduated approaches that encourage the transition to more productive and formalised businesses should be prioritised over regulations, which mandate step changes and can discourage investment and expansion.

Because of its large geographic size and low population density, the rural sector is subject to higher marketing and distribution costs and higher transactions costs of formality. Regulatory and fiscal compliance agencies tend to be far away, and the rural sector’s lower incomes mean official fees are regressive. Likewise, access to public and private services—among the benefits of formality—is less available. Hence, incentives should be provided for the financial sector and increased budgets for the judicial agencies to better service this group. BER should
also consider creating rental markets for land and real property, since leasehold tenure can be insecure or there may be restrictions constraining land leasing.

5.7 Next steps

This scoping study has revealed significant gaps in objective evidence on how BER influences formalisation among smallholder farmers and in agribusiness. More research needs to be carried out to understand how transitioning towards formality along the different dimensions set out in Section 2 of this report affects small and medium agribusiness.

Micro level analysis of agribusiness performance, including identification of the drivers of performance, and the constraints to growth, should be undertaken as part of programmes which aim to improve rural incomes and smallholder productivity. Systematic testing of the assumptions which underpin efforts to formalise the sector will help to build up the evidence base. These should look not just at the costs and benefits of formalisation, but also at the aspirations of smallholder farmers, to determine whether they actually want to become formal businesses or consider themselves as entrepreneurs, as they are often depicted in programme design.

In theory, one might want to test the impact of formalisation through randomised control trials which tested outcomes such as investment decisions, incomes or access to credit for agribusinesses that are assisted to formalise in one or more dimensions against a control group. In practice, however, programmes which work with agribusinesses are rarely designed in such a convenient manner, and usually involve a combination of activities which may include training in new techniques, subsidised access to new equipment or inputs, subsidised loans or upgrades to infrastructure, so that isolating the impact of BER and formalisation is not possible.

In practice, cruder analysis of behaviour and decision making may be required to develop circumstantial evidence which is consistent with the assumptions underpinning drives to formalise, which may rely on surveys of perceptions and intentions.

Following discussions with DFID’s Growth and Resilience Department (GRD) we set out below opportunities for further work that could be undertaken by BERF. GRD anticipates starting a Commercial Agriculture programme in 2017, which creates both priorities for developing new evidence and an opportunity for its generation.

During this scoping study, we set out to establish whether a more detailed, systematic literature review would be useful in bringing together the existing evidence. Our assessment is that it would not. We have struggled to find a significant body of evidence that focuses on agricultural sector businesses and do not consider a further, more exhaustive literature search would be productive. More targeted literature searches around specific issues that arise through the development of the Commercial Agriculture programme can be incorporated into the workflow recommended below.
In advance of the roll out of Commercial Agriculture, a more detailed analysis of previous programmes in candidate countries may be beneficial, with a specific focus on selected dimensions of formality. GRD has indicated that formal contracting may be particularly relevant for the Commercial Agriculture programme. Although this study has identified limited literature on the impact of contracting, and few DFID programmes which have obviously set out to promote formalisation, DFID Country Offices may be able to identify relevant programmes and a qualitative assessment of these will help to establish lessons and best practice. This could be undertaken either through a scoping study under the Policy Research component of BERF or as a Learning Note under the Learning component.

Once candidate countries have been selected for the Commercial Agriculture programme, a detailed diagnostic of the constraints facing agribusinesses in those countries should be undertaken to understand the potential impact of formalisation. These diagnostics will also start to build the evidence underpinning the assumptions in the theories of change for agricultural support programmes more widely. This can be carried out through further scoping studies under the Policy Research component of BERF or as diagnostic studies under the Support component.

Finally, the Commercial Agriculture programme presents an opportunity to measure the impact of formalisation of agricultural businesses which can help build the evidence available for future programmes. This would require a longer term piece of research which can be undertaken under the Policy Research component of BERF. The work should build upon diagnostics to understand the constraints to rural agribusinesses and establish a baseline of quantitative data in 2017 (ideally with a test and a control group). The baseline data should reflect the priorities of the Commercial Agriculture programme once it has been further developed. For example, a drive to increase formal contracting may consider agribusiness investment, reported access to credit, yields (productivity), employment and incomes. A paucity of data would very likely require primary research through household or business surveys. A second phase should assess the changes after one or two years. Whilst any improvements may not be conclusive evidence of the benefits of formalisation, they would at least be consistent with the hypothesis that formalisation improves agribusiness performance. A rejection of this hypothesis (e.g. through lack of any sign of improvement) would be useful for guiding future programme design.
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