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Reducing the legal obstacles faced by micro, small and medium-sized enterprises (MSMEs)

Note by the Secretariat

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Introduction

1. At its twenty-sixth session (April 2016), the Working Group considered document [A/CN.9/WG.I/WP.92](#) (paras. 86 to 88, [A/CN.9/866](#)) which had been prepared by the Secretariat to provide the overall context for work prepared by the United Nations Commission on International Trade Law (UNCITRAL) in respect of micro, small and medium-sized enterprises (MSMEs). While the Working Group did not have sufficient time to consider [A/CN.9/WG.I/WP.92](#) in detail, there was broad support for the proposal that a document along those lines could accompany its MSME work as an introduction to the final text and that it could provide an overarching framework for UNCITRAL's current and future work on MSMEs. Further, the Working Group was of the view that, once specifically considered and adopted by the Working Group and the Commission, that contextual framework could be underpinned by legal standards that would provide legislative pillars to the framework; importantly, such an approach would accommodate expansion through the addition of other legislative texts regarding MSMEs as such texts might be adopted by the Commission. Those views were noted by the Commission at its forty-ninth session (2016), at which the Working Group was commended for the progress that it had made on its work to date.¹

2. This working paper is a revised version of [A/CN.9/WG.I/WP.92](#), taking into account the general views expressed by the Working Group at its twenty-sixth session (paras. 86 to 88, [A/CN.9/866](#)), as well as appropriate material drawn from the contribution by the United Nations Conference on Trade and Development (UNCTAD) in document [A/CN.9/WG.I/WP.98](#). Necessary amendments have also been made in light of the development by the Working Group of the draft legislative guides on key principles of a business registry ([A/CN.9/WG.I/WP.106](#)) and on an UNCITRAL limited liability organization ([A/CN.9/WG.I/WP.99](#) and Add.1).

I. Micro, small and medium-sized enterprises (MSMEs)

3. At its forty-sixth session, in 2013, UNCITRAL decided to commence work on reducing the legal obstacles faced by MSMEs throughout their life cycle, and in particular, specified that such work should focus on MSMEs in developing economies. This matter was placed on UNCITRAL's work programme for Working Group I, which was requested to begin its mandate with a focus on the legal questions surrounding the simplification of incorporation.² In taking up this topic, UNCITRAL has decided to focus its attention, at least initially, on the reduction of legal obstacles that MSMEs face at the beginning of their life cycle.

4. In light of the disadvantaged position in which many MSMEs are found globally, undertaking this work emphasizes the relevance and importance of UNCITRAL's work and programmes for the promotion of the rule of law at the national and international levels and for the implementation of the international development agenda. These include the achievement of the Sustainable Development Goals, which, of course, build upon the successes of the Millennium Development Goals, and which specifically note the encouragement of the formalization and growth of MSMEs in target 3 of goal 8 to "Promote inclusive and sustainable economic growth, employment and decent work for all". The global community has recognized both the importance of fair, stable and predictable legal frameworks for: generating inclusive, sustainable and equitable development, economic growth and employment; stimulating investment; and facilitating entrepreneurship, as well as UNCITRAL's contribution to the attainment of those

¹ *Official Records of the General Assembly, Seventy-first Session, Supplement No. 17 (A/71/17)*, paras. 222 and 224.

² *Ibid.*, *Sixty-eighth Session, Supplement No. 17 (A/68/17)*, para. 321.

goals through its efforts to modernize and harmonize international trade law.³ Work aimed at supporting and fostering the establishment and growth of MSMEs further underpins UNCITRAL's contribution in providing internationally acceptable rules in commercial law, and supporting the enactment of those rules to assist in strengthening the economic fibre of States.

5. The international community has underscored the importance of business law as one of four pillars key to strengthening the legal empowerment of the poor, many of whom rely upon micro and small businesses for their livelihood.⁴ In addition to other pillars (such as access to justice and the rule of law; property rights; and labour rights), business rights are seen as important to empower the less advantaged, not only in terms of their employment by others, but in developing micro and small businesses of their own. Business rights may be regarded as a composite of existing rights of groups and individuals to engage in economic activity and market transactions, and which include the right to start a business in the legally regulated economy without facing arbitrarily enforced regulations or discrimination, removing unnecessary barriers that limit economic opportunities, and protecting business investments, regardless of their size.⁵ Measures that have been called for to strengthen business rights include:

(a) Guaranteeing basic business rights, including the right to sell, the right to have a workspace and the right to have access to the necessary infrastructure and services (for example, to electricity, water and sanitation);

(b) Strengthening, and making effective, economic governance in order to permit entrepreneurs to easily and affordably establish and operate a business, permit them access to markets, and permit them to exit a business;

(c) Expanding the accessibility of entrepreneurs to limited liability entities and to other legal mechanisms that allow owners to separate their business and personal assets;

(d) Promoting inclusive financial services that offer savings, credit, insurance, pensions and other tools for risk management; and

(e) Expanding the access of entrepreneurs to new business opportunities through specialized programmes to familiarize entrepreneurs with new markets, assisting them in creating links with other businesses of all sizes, and in complying with regulations and requirements.⁶

6. The experience of UNCITRAL may assist in the identification of the legal and regulatory framework that can best assist entrepreneurs and MSMEs in establishing business rights, thereby reducing some of the legal obstacles that such businesses face.

³ See, for example, "Declaration of the High-level Meeting of the General Assembly on the Rule of Law at the National and International Levels", United Nations General Assembly resolution [A/RES/67/1](#) (67th session, 2012), para. 8; and "Addis Ababa Action Agenda of the Third International Conference on Financing for Development (Addis Ababa Action Agenda)", United Nations General Assembly resolution [A/RES/69/313](#) (69th session, 2015), Annex, para. 89.

⁴ See, for example, "Making the Law Work for Everyone", Volume I, Report of the Commission on Legal Empowerment of the Poor (2008) (downloadable at <https://www.un.org/ruleoflaw/blog/document/making-the-law-work-for-everyone-vol-1-report-of-the-commission-on-legal-empowerment-of-the-poor/>). The findings of this Commission formed an integral part of the United Nations Development Programme's (UNDP) Initiative on Legal Empowerment of the Poor (www.undp.org/content/undp/en/home/ourwork/democraticgovernance/focus_areas/focus_justice_law/legal_empowerment.html) and have contributed to similar work on Legal Empowerment of the Poor in international organizations such as the World Bank Group.

⁵ *Ibid.*, pp. 30-31.

⁶ *Ibid.*, pp. 8-9.

A. The importance of MSMEs in the global economy

7. UNCITRAL's decision to work on reducing the legal obstacles faced by MSMEs recognizes the importance of such enterprises to the economic health of the States in which they are found, and to the global economy more generally. This importance is underscored by a number of key facts that illustrate that MSMEs are seen as the backbone of the economy in both the developed and the developing world.

8. The total number of MSMEs worldwide is estimated to be between 425 to 520 million businesses, of which 365 to 445 million (around 85 per cent) are in emerging markets. Those small and medium-sized enterprises (SMEs) operating within the legally regulated economy total 36 to 44 million globally and 25 to 30 million in emerging markets, while an additional 55 to 70 million microenterprises operate within the legally regulated economy of emerging markets. Of the total estimated MSMEs operating in emerging markets, 285 to 345 million (approximately 77 per cent) are thought to be operating outside of the legally regulated economy.⁷ In addition, SMEs (operating both within and outside of the legally regulated economy) account for 72 per cent of total employment and 64 per cent of Gross Domestic Product (GDP) in developed economies, while they represent 47 per cent of employment and 63 per cent of GDP in low-income countries. SMEs operating outside of the legally regulated economy are estimated to provide 48 per cent of all jobs in emerging market countries, and 25 per cent of all jobs in developed countries, but account for only 37 per cent and 16 per cent of GDP in these markets, respectively.⁸

9. It may also be instructive to review some of the statistics on such enterprises on a regional and subregional basis. In the European Union (EU), 99 per cent of all businesses are SMEs, which provide two out of three private sector jobs and contribute to more than half of total value-added created by business in the EU. Further, nine out of ten SMEs in the EU are microenterprises (defined in the EU as having fewer than 10 employees), thus illustrating that the mainstays of Europe's economy are micro firms.⁹

10. Microenterprises are no less influential in other developed States. For example, the United States of America has 25.5 million micro-businesses (defined as enterprises having fewer than 5 employees, including the owner), or 92 per cent of all businesses. In 2011, the direct, indirect and induced effect of microenterprises had an impact on over 40 million jobs in the United States: directly accounting for 26 million jobs; indirectly supporting 1.9 million jobs through business purchases; and having an induced effect (through the personal purchasing power of owners and employees of micro-businesses) on an additional 13.4 million jobs.¹⁰

11. MSMEs are also of great importance in regions of the world where a large number of developing States are found. SMEs represent 99 per cent of all enterprises in the Association of Southeast Asian Nations (ASEAN) region, and contribute from 30 to 60 per cent of the GDP.¹¹ In the States of the Asia-Pacific

⁷ World Bank Group Study, <http://www.worldbank.org/en/topic/financialsector/brief/smes-finance>

⁸ "IFC Jobs Study: Assessing Private Sector Contributions to Job Creation and Poverty Reduction", 2013, pp. 10-11

(https://www.ifc.org/wps/wcm/connect/0fe6e2804e2c0a8f8d3bad7a9dd66321/IFC_FULL+JOB+STUDY+REPORT_JAN2013_FINAL.pdf?MOD=AJPERES).

⁹ See European Commission's Annual report on European SMEs 2015/16: SME recovery continues (https://ec.europa.eu/jrc/sites/jrcsh/files/annual_report_-_eu_smes_2015-16.pdf).

¹⁰ See, for example, "Bigger than you think: The Economic Impact of microbusinesses in the United States", Association of Enterprise Opportunity (AEO), September 2014 (<http://microenterprisealabama.org/wp-content/uploads/2014/09/Bigger-Than-You-Think-The-Economic-Impact-of-Microbusiness-in-the-United-States-copy.pdf>).

¹¹ P. Manawanitkul, Enabling Environment for Microbusiness — ASEAN Experience, Presentation delivered at the International Joint Conference on "Enabling Environment for Microbusiness and Creative Economy, organized by UNCITRAL, the Ministry of Justice in the Republic of Korea

Economic Cooperation (APEC), SMEs account for around 97 per cent of all businesses and employ over half of the work force.¹² In the Caribbean Community and Common Market (CARICOM), MSMEs provide more than 50 per cent of GDP and account for 70 per cent of the jobs,¹³ while in Latin America, over 18.5 million MSMEs provide employment to about 70 per cent of the regional workforce and contribute almost 50 per cent of the region's GDP.¹⁴ According to the African Development Bank (AfDB), SMEs in Africa, account for more than 45 per cent of employment and contribute 33 per cent to GDP.¹⁵

B. Defining MSMEs

12. There is no standardized international definition of what constitutes an MSME, since each economy will define its own parameters for each category of business size by taking into account its own specific economic context. For the purposes of work undertaken by UNCITRAL, it is not necessary or advisable to seek consensus on a definition for each category of MSME, since any legislative texts produced will be applied by States or regional economic groups to their MSMEs as defined by each of them, based on each unique economic context. The important common factor from State to State is that MSMEs, regardless of how they are defined in that jurisdiction, are enterprises that, by virtue of being the smallest and most vulnerable, face a number of common obstacles regardless of the particular jurisdiction in which they are found. For that reason, these materials do not offer guidance on how a State should define the different categories of MSMEs.¹⁶

C. The nature of MSMEs

13. MSMEs are incredibly varied in nature. They may consist of sole entrepreneurs, small family businesses or larger enterprises with several or many employees, and may operate in virtually any commercial sector, including in the service industry and the artisanal and agricultural sectors.

14. Moreover, MSMEs may be expected to vary depending on the local economic conditions, cultural traditions and the different motivations and characteristics of the entrepreneurs establishing them. Enterprises that have entered the legally regulated economy may also take various legal forms, depending on the options available to them under applicable law, and on how those different forms may meet their needs.

15. In addition, although MSMEs may be seen, particularly in the context of developing economies, mainly as a source of livelihood for the working poor, such enterprises need not be static; in fact, MSMEs may also serve a dynamic purpose as a source of entrepreneurial talent in an economy. Indeed, their importance in the

and the Korean Legislation Research Institute, Seoul, 14-15 October 2013.

¹² See www.apec.org/Groups/SOM-Steering-Committee-on-Economic-and-Technical-Cooperation/Working-Groups/Small-and-Medium-Enterprises.aspx.

¹³ See www.oas.org/en/media_center/press_release.asp?sCodigo=E-061/12.

¹⁴ Available at www.informeavina2008.org/english/develop_case2_SP.shtml.

¹⁵ See the African Development Group News and Events page, "The AfDB SME Program Approval: Boosting Inclusive Growth in Africa", 2013, available at www.afdb.org/en/news-and-events/article/the-afdb-sme-program-approval-boosting-inclusive-growth-in-africa-12135.

¹⁶ States may wish to note the definitions of the different categories of businesses included in MSMEs that have been established either by various States or by regional economic groups. Those definitions tend to be based on a number of elements, considered separately or along with other factors, including: (i) the number of employees at a specific point in time, such as the end of the financial or calendar year; (ii) the amount of annual revenue or turnover generated by the enterprise, or the balance sheet total of the business; (iii) the asset base of the business; (iv) the total monthly wages paid by the enterprise; or (v) the amount of capital invested in the enterprise.

world economy suggests that providing for and fostering the growth of MSMEs is a key goal in order to achieve economic progress, innovation and success.

16. However, despite their disparate nature, certain characteristics of MSMEs may be broadly shared. Some of these similarities may include, among others:

- (a) Being and remaining small operations;
- (b) Facing burdensome regulatory hurdles, which tend to have a disproportionate effect on them;
- (c) Reliance on family and friends for loans or risk-sharing;
- (d) Limited access to capital or to banking services;
- (e) Employees, if any, are often drawn from family and friends and may be unpaid and unskilled, including having limited administrative capacity;
- (f) Markets may be limited to relatives, close friends and local contacts;
- (g) Vulnerability to arbitrary and corrupt behaviour;
- (h) Limited access to dispute settlement which puts them at a disadvantage in disputes with the State or with larger businesses;
- (i) A lack of asset partitioning, so business failure often means that personal assets are also lost;
- (j) Vulnerability to financial distress; and
- (k) Difficulty in transferring or selling a business and in profiting from both tangible and intangible assets (such as client lists or relationships with customers).¹⁷

D. Creating sound business environments for all businesses

17. Efforts to assist MSMEs at the start of their life cycle might first begin with consideration of the business environment in which an MSME will be conducting its affairs. A “business environment” may be defined in a number of different ways, but could be said to comprise the policy, legal, institutional and regulatory conditions that govern business activities, as well as the administration and enforcement mechanisms established to implement government policy, and the institutional arrangements that influence the way key actors operate. These key actors may include government agencies, regulatory authorities, business organizations, trade unions, and civil society organizations. All of these factors contribute to affect business performance.¹⁸

18. Sound business environments clearly have a positive influence on economic growth and poverty reduction. Views differ as to the significance and measurability of the link between the business environment, on one hand, and economic growth and poverty reduction, on the other. However, poor business environments may not provide sufficient incentive and opportunity for entrepreneurs to carry on their commercial activities in the legally regulated economy where their enterprise is more likely to thrive. In addition, poor business environments tend to be more susceptible to corruption and usually have a disproportionate gender impact, since the businesses most vulnerable in a weak business environment are micro-businesses, which are often owned by women.¹⁹

19. It should be noted that the quality of the business environment varies not only as between States but within their different regions as well. Such regional variations make it unlikely that a single solution will provide the answer for improving the

¹⁷ See, for example, *supra* note 4, pp. 8-9, 38-39 and 70-73.

¹⁸ Donor Committee for Enterprise Development (DCED), 2008, “Supporting Business Environment Reforms”, p. 2.

¹⁹ *Ibid.*, p. 3; see also, “Making the Law Work for Everyone”, Volume I, Report of the Commission on Legal Empowerment of the Poor, *supra* note 4.

business environment in every State. Similarly, the challenges faced by entrepreneurs, particularly by MSMEs, vary depending on the context in which they are doing business. However, the two concepts are linked, since many of the challenges faced by MSMEs are similar to those considered detrimental to a favourable business environment in general, including: burdensome regulation, high economic inequality, low institutional quality, low quality of public infrastructure, and a lack of access to credit and other resources.²⁰

20. Improving the quality of the business environment and assisting MSMEs in overcoming the particular challenges facing them often require a State to take measures towards legal and policy reform. These reforms may include, among others, providing for a simple and effective system of business registration, as well as providing for a range of simplified and flexible business forms so as to meet the varied needs of MSMEs. States most often initiate such business reforms in order to: facilitate business start-up and operations, stimulate investment opportunities, and increase growth rates and employment. Such reforms require careful planning and commitment on the part of the State, as well as the involvement of many different entities at various administrative and governmental levels.²¹

II. The extralegal economy

21. As outlined above in paragraph 16, MSMEs generally face a number of key challenges, some of which are caused, and many of which are exacerbated, by operating in the extralegal economy.²² As noted above, developing States host over 85 per cent of the large number of MSMEs in business globally; of these, an estimated 77 per cent of MSMEs operate in the extralegal economy, which is sometimes referred to as the “informal” economy.

22. “Informality” is by no means a uniform concept. Many “informal” businesses actually operate in fixed premises and according to locally accepted commercial rules. In addition, they may be well-known by local authorities, pay some form of local taxes, and may even engage in cross-border trade. Others, on the other hand, may have little interaction with the State.

23. Although measurement tools are imperfect and no clear boundaries exist between formal (or legally regulated) and informal (or extralegal) sectors, businesses can be viewed as operating on a formality-informality (or legal-extralegal) spectrum. They can be qualified as more or less formal or informal according to the extent to which their operations fall within the ambit of a State’s official laws or take place outside of its official structures. Reference in these materials to the “legally regulated economy” thus refers to the sector of the economy characterized by activities that are conducted within the ambit of formal regulation and structure and commercial activity that falls outside of this scope will be referred to as “extralegal” rather than “informal”. Moreover, since the entry point for businesses wishing to access the legally regulated economy is often by way of registration with a commercial or business registry, extralegal enterprises will refer to those that are not entered into the official commercial or business registry of a State, such registration will be considered in these materials to be the main conduit through which businesses are encouraged to operate in the legally regulated economy.

24. It should also be noted that the extralegal economy is not related to illegal or criminal activity. Illegal activities are contrary to the law, but informal activities are

²⁰ See K. Kushnir, M. L. Mirmulstein and R. Ramalho, “Micro, small and medium enterprises around the world: How many are there, and what affects their count?”, 2010, World Bank/IFC.

²¹ See Donor Committee for Enterprise Development (DCED), Supporting Business Environment Reforms: Practical Guidance for Development Agencies, Annex: How Business Environment Reform Can Promote Formalisation, 2011.

²² See, for example, A. M. Oviedo, M. R. Thomas, K. K. Özdemir, Economic Informality, causes, costs and policies — a literature survey, 2009, pp. 14 et seq.

extralegal, in that they are not officially declared and do not occur in the context of the legal and regulatory regime that should govern such activities. The discussion in these materials is limited to extralegal commercial activities and does not address trade in illicit goods or services.

25. In addition, extralegal commercial activity may be mainly of a different nature in some States, such as in developed economies. In such States, the extralegal economy may consist mainly of formal firms and workers that underreport their income to tax authorities, or that use undeclared labour in certain business domains.²³ These types of extralegal activities are not the focus of these materials.

26. It is also important to note that although extralegal commercial activity, particularly in the developing world, may exist largely as a result of economic necessity (as noted above in respect of MSMEs in general)²⁴ components of the extralegal economy may also be seen as quite dynamic and as an incubator for business potential that in fact provides economies with a large number of potential contributors to business development. In fact, businesses operating in the extralegal economy may be seen to provide a pool of talent and an important base of operations from which entrepreneurs can access, and graduate into, the legally regulated economy. There is increasing recognition that the extralegal sector is growing and that it should not be considered a marginal or peripheral sector, but rather as an important building block of a State's overall economy.²⁵

27. In fact, a majority of the world's working population operates in the extralegal economy; that number is projected to grow to two-thirds of the global work force by 2020.²⁶ Although the very nature of such enterprises prevents the identification of precise statistics, estimates of the regional prevalence of extralegal economic activity as a percentage of GDP are as follows: 38 per cent in sub-Saharan Africa; 18 per cent in East Asia and the Pacific; 36 per cent in Europe and Central Asia; 35 per cent in Latin America and the Caribbean; and 27 per cent in the Middle East and North Africa. By way of comparison, the level of the extralegal economy as a percentage of GDP is estimated at 13 per cent in high-income Organisation for Economic Co-Operation and Development (OECD) States, and at 17 per cent globally.²⁷

28. The institution of reforms to improve the business environment, as noted above in paragraphs 17 to 20, may encourage and facilitate the creation of enterprises through official registration and the migration of extralegal businesses to the legally regulated economy. However, in order to achieve success, policies that encourage businesses to enter the legally regulated economy should take into account the different motivations and characteristics of entrepreneurs operating in the extralegal sector. Such motivations will vary depending on the economy, and may include: micro and small businesses that cannot access the legally regulated economy due to high entry barriers and costs (including taxes and other social contributions) or lack of information; subsistence entrepreneurs that lack alternative job opportunities; and those entrepreneurs that consider that the costs of entering the legally regulated economy outweigh the benefits they expect to receive.²⁸

29. Variations in the size and characteristics of the extralegal economy are also apparent from region to region. An analysis of one region, for example, indicates

²³ Ibid., pp. 6 et seq.

²⁴ See para. 15 above.

²⁵ See, for example, UNCTAD's information on business facilitation (www.businessfacilitation.org/topics/formalization/).

²⁶ "How to formalize the informal sector: Make formalization easy and desirable", UNCTAD, (www.businessfacilitation.org/topics/formalizing-the-informal-sector.pdf).

²⁷ "Economic Developments in Africa Report, 2013: Intra-African Trade: Unlocking Private Sector Dynamism", UNCTAD, pp. 65-66 (http://unctad.org/en/PublicationsLibrary/aldcafrica2013_en.pdf).

²⁸ M. Jaramillo, "Is there demand for formality among firms?", Discussion paper, 2009, pp. 2 et seq; see also "Enterprise Surveys — Enterprise Note Series: Formal and Informal Microenterprises", World Bank Group, Enterprise Note No. 5, 2009.

high levels of extralegal commercial activity, partially due to the fact that the extralegal economy is where most new jobs are found, and in which many entrepreneurs must trade by necessity.²⁹ In this region, a job, an enterprise and a household are often the same thing,³⁰ and lack of entrepreneurial skills, access to credit, and infrastructure are seen as the most restrictive constraints to growth. In other regions, the extralegal sector tends to behave like a typical small business sector, and is often the main entry point for young, uneducated workers seeking employment, as well as for those seeking part-time work.³¹ Other regions have experienced growth of the extralegal economy in recent years, apparently driven by a lack of jobs in the legally regulated sector and reduced demand for goods and services from those employed in that sector.³²

30. The debate on the reasons for the extralegal sector, on its effect on national economies and on how to approach the issue has been vibrant for decades and has in recent years had a major influence on policymaking. The view that extralegal commercial activity is the result of burdensome regulation and costly procedures required by the State for businesses to enter the legally regulated economy, and that a reduction of those barriers will help extralegal MSMEs move towards a higher degree of business registration, has generated strong momentum for reforming regulations and laws in order to simplify business entry into the legally regulated economy.³³ A wide array of policies have been designed and implemented in several States and regions of the world, since, as noted earlier, the variable nature of the extralegal sector, and the different levels of development of States, render elusive the identification of a single optimal approach. The most successful interventions have been comprehensive policy packages that aimed at achieving various goals, such as economic growth, social protection, and inclusion, and which often include:

(a) Reducing the costs of a business entering (and remaining in) the legally regulated sector, which include entry costs, taxes, fees and social contributions, and costs of compliance;

(b) Improving the benefits of entering the legally regulated economy by reducing the bureaucracy and expense involved in obtaining fixed premises, and obtaining access to business development services and new markets;

(c) Improving the general business environment, so that policies to reduce costs and to improve the benefits of entering the legally regulated economy also assist firms already operating in that sector; and

(d) Strengthening the enforcement of a State's legal regime in order to encourage entry to the legally regulated economy.³⁴

III. Making entry into the legally regulated economy simple and desirable for MSMEs

31. In order to encourage MSMEs to start their business in the legally regulated economy or to move their extralegal businesses into that sector, States may wish to consider how best to effectively convey to MSMEs the availability and advantages

²⁹ See Sub-Saharan Africa; UNIDO, GTZ, 2008, *Creating an enabling environment for private sector development in sub-Saharan Africa*, p. 16.

³⁰ See Sub-Saharan Africa, Donor Committee for Enterprise Development (DCED), 2009, *Business Environment Reforms and the Informal Economy — Discussion Paper*, p. 2.

³¹ See Latin American and Caribbean States; Donor Committee for Enterprise Development (DCED), 2009, *Business Environment Reforms and the Informal Economy — Discussion Paper*, p. 2.

³² See Asia and southeast Europe; Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), website, *Toolkit: Learning and Working in the informal economy*, www.giz.de/expertise/html/10629.html.

³³ *Supra*, note 28, pp. 2 et seq.

³⁴ International Labour Organization (ILO), GIZ, *Enterprise formalization: fact or fiction?, A quest for case studies*, 2014, p. 24.

of that approach. In addition, States should also consider what steps they can take to motivate such behaviour by making it a desirable, easily accessible process, which will pose the least burden possible on the MSME.

A. Explain what entering the legally regulated economy means

32. To ensure widespread understanding of the advantages available to MSMEs, steps must be taken to explain to them the meaning of participating in the legally regulated economy and to provide clear and accessible information to them on how to achieve that aim. The State should consider how best to effectively convey relevant information to MSMEs, including how such businesses can register in the jurisdiction (whether they are required or merely encouraged to do so), the minimum requirements for registration and any other information necessary for them to operate in the legally regulated economy. This information should advise entrepreneurs of the benefits of official registration, as well as which legal business forms are available to them and the advantages of each, and which additional registrations might be necessary, for example for the purposes of licensing, taxation, social services, and the like. Ideally, a business should be able to use a single physical or electronic interface (a “one-stop shop”) to register simultaneously with all necessary public authorities. Information in respect of these matters should be specifically adapted so that it is clear and easily understandable for the target audience, and it should be conveyed in a manner that is tailored for them.

1. The advantages of the legally regulated economy

33. Part of the message that must be conveyed to MSMEs in order to persuade them to operate their businesses in the legally regulated economy is to explain to them the advantages of that approach. The following sections outline the advantages of encouraging businesses to operate in the legally regulated economy for both the State and for entrepreneurs.

(a) Advantages for the State

34. States have a clear interest in encouraging MSMEs to operate in the legally regulated economy. One of the reasons often cited for that interest is in terms of taxation, since encouraging MSMEs to migrate to, or to operate in, the legally regulated economy will broaden the tax base of the State.³⁵ It may also help reduce any friction that may exist with enterprises that are already operating in the legally regulated economy and are tax contributors, but that must compete for market share with extralegal businesses. However, there are additional reasons for the State to take action to encourage businesses to operate in the legally regulated economy, such as, depending upon the specific economic sector, ensuring consumer protection and in generally engendering trust in business and commerce in the State for stakeholders including consumers, business partners and banks.

35. Other advantages to the State may be less direct, but are no less valuable. For example, providing previously extralegal businesses with the means to enter the legally regulated economy will permit those MSMEs to grow, to create jobs, and to increase their earnings and contribution to the creation of wealth and the reduction of poverty in the State. Businesses that enter the legally regulated economy can be expected to attract more qualified employees and to stay in business longer, thus making investment in the training of personnel and the acquisition of capital more profitable. The increase in the number of businesses registered will mean that there is more and better economic data available by way of the business registry, and that information exchange in respect of such businesses will increase and become more

³⁵ States may wish to note that reduced taxation rates and administration may be an incentive offered to MSMEs to join the legally regulated economy, and that too great an emphasis on expanding the tax base may be counterproductive.

transparent. All of these effects will have an overall positive impact on the economy of the State.³⁶

(b) Advantages for entrepreneurs

36. States must also ensure to convey clearly and effectively to MSMEs and entrepreneurs the benefits of doing business in the legally regulated economy. The following factors are often cited as key advantages for MSMEs that operate in that commercial context.

(a) Visibility to the public and to markets

Registering a business is the primary means through which it becomes visible to the public and to markets, thus providing a means for exposure to potential clients and business contacts, and an expansion of market opportunities. This membership in the marketplace may provide opportunities both in terms of becoming a supplier of goods and services and in accessing them under favourable conditions, and can dramatically improve the profitability of the business. Moreover, such visibility enables, and reduces the costs of, MSMEs trading in economic circles beyond their relatives, friends and local contacts, thus opening up new markets for them.

(b) Visibility to the banking system and financial institutions

Business registration can also provide an enterprise with improved access to banking and financial services, including to bank accounts, loans and credit. This permits MSMEs to move away from financial reliance on relatives and friends and makes it easier for them to raise capital from a broader group of investors, as well as lowering the cost of that capital. This, in turn, permits businesses to expand, to make new investments, to diversify their risk, and to take up new business opportunities.

(c) Public procurement

In most States, public procurement contracts are only available to those businesses that are registered and are part of the legally regulated economy. Access to such contracts may be enhanced for certain groups, since some States have developed specific programmes to ensure that a certain percentage of public procurement contracts are granted to less entitled entrepreneurs, including women, youth, the disabled and the elderly.

(d) Legal validation

Officially registering a business permits it to operate commercially in the jurisdiction and provides the entrepreneur with documentation proving that status, and that the business is in compliance with the registration requirements. This status also permits registered businesses to enter into and enforce contracts more easily, and to have access to justice for commercial purposes, including in respect of reorganization or liquidation. In some legal systems, registration provides additional legal rights for the entrepreneur operating in the commercial sector, including flexible provisions on commercial contracts, specialized commercial court divisions, a relaxation of certain requirements in terms of legal form, and the like.

(e) Legal compliance

While related to the concept of legal validation, compliance with the law can itself be seen as an advantage, since it alleviates entrepreneurial anxiety in respect of operating extralegally, and makes it less likely that fines may be imposed. Being in compliance with the law will also reduce the business' vulnerability to corruption and bribery, and should assist the entrepreneur by providing recourse in cases of tax and other inspections.

³⁶ See, for example, *supra*, note 22, pp. 14 et seq.

(f) Access to flexible business forms and asset partitioning

Through registration, the entrepreneur will be entitled to choose the legal form available in the jurisdiction that is best suited for the business, and ideally, the State will provide for a range of legal business forms for that purpose. Most jurisdictions have at least one legal form that permits the entrepreneur to separate personal finances from business finances; such asset partitioning can be invaluable to a business, particularly if financial difficulty is encountered, as the entrepreneur is not in danger of losing all personal assets, and the value of the business assets can be maximized in the case of reorganization or liquidation. Moreover, the value of a business with separate assets may be greater and can be more readily transferred.

(g) Unique name and intangible assets

Business registration usually requires an enterprise to operate under a sufficiently unique business name. This unique name translates through the business registry and other means into a market identity that can develop a value of its own, and that can be traded to a subsequent owner. Other intangible assets that can add to the value of a business and can be traded, particularly in the case of asset partitioning and a separate legal business identity, include client lists and commercial relationships.

(h) Opportunities for growth

In addition to the advantages of visibility set out above, business registration provides an enterprise with access to a much larger business network, which can permit it to grow the business and operate it on a much greater scale. Some States permit a registered business to become a member of the Chamber of Commerce or other trade organization, which can greatly enhance an enterprise's opportunities for development.

(i) Opportunities for specialization of labour

Registered businesses tend to be less constrained in their hiring practices and may be able to hire employees outside of family and friends. This can permit the business to have access to a larger pool of talent and to permit specialization among employees to make better use of their talent and improve overall productivity.

(j) Access to government assistance programmes

Many States provide specific assistance programmes for MSMEs or for specific types of disadvantaged entrepreneurs. Registration in the legally regulated economy will permit an enterprise to access all forms of government assistance available to such businesses.

(k) Empowerment and emancipation effects

Registration of businesses owned by women, youth, the disabled, the elderly and other less advantaged groups may have important empowerment and emancipation effects. This may be particularly so in respect of women entrepreneurs, many of whom are micro entrepreneurs and who are often exposed to greater risk as a result of corruption and abuse of authority.

(l) Longer term gains

Business registration is also the main conduit for the growth of an enterprise into cross-border trading. It is also possible that, in the longer term, and particularly through the use of electronic commerce and Internet facilities, robust business registration will lead to an increase in cross-border trading and foreign investment — advantages not only for the enterprise, but for the State as well.

2. Communication and education

37. Communication of, and education on, the advantages of legal and policy reforms undertaken by the State to assist MSMEs will be key to the success of those reforms. While this might seem a relatively small detail, in the context of States and

regions in transition or with remote areas, all potential entrepreneurs may not be well-served by mass media or have dependable and regular access to telecommunications or the Internet. In such contexts, the potential obstacles to communication and education, and thus to the success of the reforms, can be expected to be more numerous.

38. An additional consideration for a State in developing communication and education strategies should be to consider that many micro entrepreneurs may face literacy challenges and that particular steps may need to be taken to overcome this hurdle. For example, pictograms could be used in addition to text in order to inform potential businesses of the programmes and advantages offered to them. Additional options could include using other culturally significant means of communicating with such groups, including through songs and storytelling. One example demonstrates how,³⁷ in order to publicize its programmes aimed at fostering micro entrepreneurs, a State launched a national campaign illustrating the benefits of those programmes by way of broadcasting on radio and television a simple and interesting scenario using well-known national actors performing in the national languages of the State.

39. In designing its communication and education plan, a State must be cognizant of the potential impediments outlined above and think practically how best to bridge such gaps. Possible solutions could include:

(a) Providing for mobile education and communication efforts, and for mobile business registration and facilitation counters, so as to enable travel to the entrepreneur's location;

(b) Using trade organizations or informal workers' associations to assist in publicizing the programmes;

(c) Using mass media that is broadly available, including radio, television and print media, as well as posters and billboards;

(d) Making blanket announcements via text on mobile phones; this may be particularly effective in areas where mobile payments are being used;

(e) Ensuring that communication and education is in the local language;

(f) Making use of social media; while less practical in terms of States that face technological hurdles, social media may be an effective tool, particularly to disseminate information among younger entrepreneurs and family members;

(g) Developing courses for gender-specific trading or involving other disadvantaged groups could be developed; and

(h) Using educational techniques that may be particularly useful in the context.³⁸

³⁷ See, for example, efforts of the Democratic Republic of Congo in publicizing its OHADA "entreprenant" programme (www.ohada.com/actualite/2609/ohada-rdc-campagne-mediatique-de-sensibilisation-sur-l-entreprenant-communication-de-la-commission-nationale-ohada-de-rdc.html). A sample video may be viewed here: www.youtube.com/watch?v=IE1OIo1eNic.

³⁸ One such method may be "participatory learning and action", which has been described as an approach traditionally used with rural communities in the developing world. It combines participatory and visual methods with natural interviewing techniques and is intended to facilitate a process of collective analysis and learning. The approach can be used in identifying needs, planning, monitoring or evaluating projects and programmes, and offers the opportunity to go beyond mere consultation and promote the active participation of communities in the issues and interventions that shape their lives. See, for example, "What is Participatory Learning and Action (PLA): An Introduction", Sarah Thomas (<http://idp-key-resources.org/documents/0000/d04267/000.pdf>) or www.iied.org/participatory-learning-action.

B. Make it desirable for MSMEs to enter the legally regulated economy

40. Another component of the communication package that should be conveyed to prospective business registrants is clear information on the incentives that a State provides to MSMEs to encourage them to register and participate in the legally regulated economy.

41. The effectiveness of the incentives offered by the State will vary according to the specific economic, business and regulatory context. As such, it is not possible to specify precisely which incentives should be offered to encourage businesses to operate in the legally regulated economy. However, States may wish to consider the following possible incentives, each of which, often in combination with others, has been found to be an effective means of encouraging MSMEs to enter the legally regulated economy. In addition, in planning for the creation of these incentives, States may need to ensure coordination with international organizations active in this area (including, for example, the World Bank Group, UNCTAD, UNIDO, the Asian Development Bank, or OHADA), business registration officials, local business incubators, the tax authority, and banks in order to maximize the impact of the incentives chosen.

42. The following is a non-exhaustive list of the incentives that States may consider offering to MSMEs in order to persuade them to operate their businesses in the legally regulated economy or to migrate them from the extralegal economy.³⁹ A State may consider programmes along the following lines:

- (a) Simplification of the business registration process;
- (b) Assistance in the business registration process;
- (c) Free (or at least very low-cost) business registration;
- (d) Receipt of an official certificate indicating the registered status and legal form of the business;
- (e) Organized access to and support with banking services (bank accounts and chequing accounts);
- (f) Promoting access to credit for registered businesses;
- (g) Accounting training and services, and ensuring simplified accounting rules suitable for MSMEs;
- (h) Assistance in the preparation of a business plan;
- (i) Training (including managing inventory and finances);
- (j) Providing credits for training costs;
- (k) Protection against potential administrative abuse, possibly through access to mediation or other dispute resolution;
- (l) Simpler and more equitable taxation (lower, simplified taxation rates), including tax mediation services and simplified tax forms;
- (m) Business counselling services;
- (n) Permitting a transition period to give new businesses time to comply fully with applicable laws;
- (o) Providing a temporary “tax holiday” for small and microenterprises upon their initial registration;

³⁹ The Working Group may wish to note that each of these incentives, and any additional ones suggested for inclusion, could be described in a brief paragraph, if desired.

(p) Providing lump sum monetary compensation or government subsidies and programmes⁴⁰ to foster MSME growth;

(q) Providing public communication and promotion of the registered business, as well as networking opportunities and access to experienced businesses, for example through free memberships in industry organizations;

(r) Tailoring specific public procurement programmes to encourage small and micro-businesses or those owned by disadvantaged groups to have access to contracts;

(s) Providing low-cost technological infrastructure;

(t) Promoting access to and support with obtaining health insurance; and

(u) The establishment of a business mentoring programme with experienced business owners to facilitate access to experience and information for MSMEs.

C. Make it easy for MSMEs to enter the legally regulated economy

43. In addition to a lack of information, one of the most often-cited reasons given by MSMEs for their reluctance to register their business is the cost and administrative burden of doing so. Two areas of reform that States may undertake to assuage these concerns are to simplify and streamline the procedures necessary to register a business, focussing on the needs of the user, and to provide for flexible and simplified business forms for MSMEs.

1. Simplified and streamlined business registration

44. One aspect of making it simple and desirable for an MSME to operate its business in the legally regulated economy is to take a user-centric approach and to make the procedures for business registration accessible, simple and clear. In order to facilitate the operation of MSMEs in the legally regulated economy, States may wish to take steps to rationalize and streamline their system of business registration. Improvements made by a State to its business registration system may be expected to assist not only MSMEs, but businesses of all sizes, including those already operating in the legally regulated economy. Importantly, care must also be taken to effectively communicate these changes and their advantages to MSMEs and potential entrepreneurs throughout the jurisdiction.

45. The draft legislative guide on key principles of a business registry ([A/CN.9/WG.I/WP.106](#)) explores in detail the steps that can be taken by a State to simplify, streamline and adopt good practices in its system of business registration.

2. Flexible and simplified business forms for MSMEs

46. Another aspect of creating an enabling legal environment and an attractive business registration programme for MSMEs is for the State to permit them simple access to flexible, legally recognized business forms. Many micro and small businesses are either sole proprietorships or family enterprises that do not possess a legal identity or a business form distinct from that of the owner. An entrepreneur should be permitted to easily and inexpensively register a business with a legally recognized form in that jurisdiction. States may wish to permit business registration of a range of different legal forms so as to provide entrepreneurs with sufficient flexibility to meet the needs of MSMEs, and to encourage their registration and foster their growth.

47. For some businesses, registering in the official business register as a simple sole proprietor may be sufficient for their purposes. However, some States and regional economic organizations have created a legal business form for individual

⁴⁰ For example, some States have programmes to encourage young nationals who have been educated abroad to return to their State and start businesses.

entrepreneurs (defined as those whose business turnover is below a certain amount) which adds through simple business registration certain benefits to those otherwise available to the sole proprietor.⁴¹ These benefits tend to include being subject to a simplified scheme for the calculation and payment of taxes and social security contributions, as well as fast, simplified and low (or no) cost registration requirements and formalities. In addition, States may also adopt a number of incentives available to such businesses which may include: assistance in opening a bank account and gaining access to banking services, access to mediation services (for example, in respect of taxation and legal services) and practical training and advisory services in key business areas (for example, in accounting, management and inventory, legal and tax obligations, financial education and awareness, business planning, and restructuring and growth strategies). Nonetheless, such schemes typically do not change the unlimited personal liability of a sole proprietor, whose personal and professional assets are all available to meet any business debt.

48. An important business right that should be offered to MSMEs is the opportunity for an enterprise to partition its business assets from the personal assets of its owner(s). The legal ability of an enterprise to partition its business assets from the personal assets of its owner(s) is an important building block for the encouragement of entrepreneurial activity since, even though a business may fail, the personal assets of the entrepreneur(s) will be protected.

49. Asset partitioning is seen as one of the defining features of a limited liability business entity, which is said to be among the most productivity enhancing legal institutions available. Offering entrepreneurs the opportunity to take on legal personality and limited liability through the adoption of a simplified business form is certainly a feature that States should consider in making policy decisions on legal forms to adopt in order to reduce the legal obstacles encountered by MSMEs. The key issues involved in adopting a legal regime for simplified business entities with these features, but adapted for MSMEs (including sole proprietors), is considered in detail in the draft legislative guide on an UNCITRAL limited liability organization (A/CN.9/WG.I/WP.99 and Add.1). However, it should be noted that the benefits of asset partitioning for MSMEs registering their businesses may also be available in a legal structure that stops short of full limited liability and legal personality, and is thus subject to fewer formal requirements.

50. One such model that has been adopted is that which permits an individual entrepreneur to officially allocate (and register with the business registry) a certain share of personal assets to the entrepreneur's professional activity. This approach permits the entrepreneur to segregate professional assets from personal assets so that, in the event of financial difficulty of the business, creditors will have access only to the professional assets of the entrepreneur.⁴²

51. Another model that has been used in this regard is the establishment of a separate capital fund that has been established for a specific purpose. Such a fund may be established by individuals (and their spouses), into which specific assets can be placed that are identified as necessary for the family requirements of the individuals. Such assets are then protected from seizure in the case of business insolvency. A variation on this model may also be created by a corporation, which can establish a separate capital fund devoted to a specific purpose or which can agree that the earnings of an activity be dedicated to the repayment of loans obtained for the execution of certain specified activities. The establishment of such a fund is subject to certain requirements, including that its existence be made public by way of the business registry, and that it be open to opposition by existing

⁴¹ See, for example, the "entrepreneur with limited liability" (EIRL) or the "auto-entrepreneur" in France (A/CN.9/WG.I/WP.94 and A/CN.9/WG.I/WP.87, paras. 22-23, and pp. 10 et seq., respectively), or the "entreprenant" in OHADA, Acte Uniforme Révisé Portant sur le Droit Commercial Général, adopted 15 December 2011, entry into force 16 May 2011 (www.ohada.com/actes-uniformes/940/acte-uniforme-revise-portant-sur-le-droit-commercial-general.html).

⁴² See A/CN.9/WG.I/WP.87, paras. 26-27.

creditors of the corporation. Once the fund is constituted, it is segregated from the other funds of the company, and may only be used to satisfy the claims of creditors arising as a result of the relevant activities. Other variations on the creation of a segregated fund may include the declaration of the fund to a specific purpose to the benefit of a natural or legal person, a public administrative body, or other entity, provided that the fund is established by public deed and is registered.⁴³

52. An additional example of asset partitioning that stops short of providing legal personality and limited liability is the concept of “business network contracts”. This legal tool can be used by a group of entrepreneurs (of various types and sizes, including sole proprietors, companies, public entities, and non-commercial and not-for-profit entities) who undertake a joint venture as agreed in the business network contract, which may be in respect of certain services or common activities within the scope of their business, or even with respect to the exchange of information. The goal of such an approach is to strengthen the individual businesses involved in the contract, as well as the network itself, at the national and international levels, so as to enable access to business opportunities not available to an individual enterprise, and thus to improve competitiveness. The contract must meet the formal requirements established by the State (for example, be duly executed in writing, indicate the objectives of the venture, its duration, the rights and obligations of participants, etc.), and be registered with the business registry. In addition, the contract must establish a capital fund to carry out the programme of the business network; this fund is then segregated from the individual assets of the founding entrepreneurs, and is available only to satisfy claims deriving from the activities performed within the scope of the network, and not for creditors of the individual entrepreneurs that created the business network.⁴⁴

⁴³ See [A/CN.9/WG.I/WP.87](#), paras. 2-7.

⁴⁴ See [A/CN.9/WG.I/WP.87](#), paras. 8-17.