

Digital Payments and the Formalization of Informal Economies

Dr. Anne-Laure Delatte

Senior Researcher, Sciences Po, Paris, France

Abstract

The rapid expansion of digital payment systems has created significant opportunities for transforming informal economic activities into more structured and financially integrated systems. Informal economies, which include small-scale businesses, self-employed workers, and unregistered enterprises, often operate outside formal financial institutions due to limited access to banking services, documentation barriers, and restricted financial resources. Digital payment technologies provide new mechanisms for improving financial inclusion, transaction transparency, and economic participation among informal-sector participants.

This study examines the role of digital payments in supporting the formalization of informal economies. The research explores how electronic payment systems influence financial inclusion, transaction visibility, business registration incentives, access to credit, and economic integration. A conceptual analytical framework supported by simulated observations is developed to evaluate the contribution of digital payment adoption toward the transition of informal activities into formal economic structures.

The findings indicate that digital payments can enhance economic formalization by improving financial records, increasing access to financial services, supporting business growth, and encouraging participation in formal financial systems. However, challenges including digital literacy limitations, cybersecurity risks, technology accessibility gaps, transaction costs, and trust issues continue to affect widespread adoption.

The study contributes to digital finance and development economics literature by explaining how payment innovation can support inclusive economic transformation. The findings provide practical implications for policymakers, financial institutions, technology providers, and informal-sector entrepreneurs seeking to promote digital financial integration.

Keywords: Digital Payments, Informal Economy, Financial Inclusion, Economic Formalization, Digital Finance, Electronic Transactions, Small Businesses.

1. Introduction

Informal economies represent a significant component of economic activity in many developing and emerging markets. Millions of individuals and small enterprises operate outside formal financial and regulatory systems due to limited access to banking services, lack of documentation, regulatory barriers, and restricted economic opportunities. Although informal activities contribute substantially to

employment generation and household income, their limited integration with formal financial systems creates challenges related to business growth, credit access, taxation, and economic measurement.

The development of digital payment technologies has introduced new possibilities for improving the connection between informal economic activities and formal financial systems. Mobile payments, digital wallets, electronic transfers, and online transaction platforms enable individuals and small businesses to conduct financial transactions without relying exclusively on cash-based systems. These technologies can create transaction records, improve financial visibility, and support greater participation in formal economic networks.

Digital payments may contribute to economic formalization by encouraging informal businesses to adopt structured financial practices. Transaction histories generated through digital platforms can help entrepreneurs demonstrate business activity, access formal credit, and establish financial identities. For financial institutions and policymakers, digital payment data can provide valuable insights into economic behaviour and support the development of inclusive financial policies.

Despite these potential benefits, the transition from cash-based informal activities to digital financial systems involves several challenges. Limited digital literacy, inadequate technological infrastructure, concerns regarding privacy and security, and resistance to formal financial systems may restrict adoption among informal-sector participants. Therefore, understanding the relationship between digital payment adoption and economic formalization is essential for developing effective financial inclusion strategies.

The motivation of this study arises from the growing importance of digital finance in transforming economic structures. This research examines how digital payment systems contribute to the formalization of informal economies and identifies the opportunities and challenges associated with digital financial integration.

2. Review of Literature

2.1 Informal Economies and Financial Exclusion

Informal economies have traditionally been associated with limited access to formal financial services, regulatory systems, and institutional support. Small businesses and self-employed individuals often rely on cash transactions due to difficulties in accessing banking services and formal credit mechanisms.

Research indicates that financial exclusion is one of the major barriers preventing informal enterprises from achieving sustainable growth. Limited financial records, lack of collateral, and insufficient documentation often restrict access to formal economic opportunities.

The literature highlights that improving financial inclusion is essential for enabling informal-sector participants to participate more effectively in formal economic systems.

2.2 Digital Payments and Financial Inclusion

Digital payment systems have emerged as important tools for expanding financial access and reducing dependence on cash-based transactions. Mobile payment platforms and electronic financial services enable individuals and businesses to conduct secure transactions while creating valuable financial records. Studies suggest that digital payments can improve economic participation by reducing transaction barriers, increasing convenience, and connecting underserved populations with formal financial services.

The literature indicates that digital payment adoption can support broader financial inclusion when combined with appropriate infrastructure, digital literacy, and supportive policies.

2.3 Digital Payments and Economic Formalization

Economic formalization involves the transition of informal activities into recognized and integrated economic systems. Digital payment adoption may support this transition by improving transaction transparency, encouraging financial documentation, and enabling access to formal financial services.

Research suggests that digital transaction records can help small businesses establish financial credibility and improve opportunities for credit access and business expansion.

However, successful formalization requires more than technological adoption. Supportive regulations, affordable financial services, and trust-building measures are necessary to ensure sustainable integration of informal economies.

3. Objectives of the Study

3.1 Research Purpose

The primary purpose of this study is to examine the role of digital payments in supporting the formalization of informal economies. As digital financial technologies expand, electronic payment systems are increasingly becoming important tools for improving transaction transparency, financial inclusion, and economic participation among informal-sector businesses and workers.

The study aims to understand how digital payment adoption contributes to the transition from cash-based informal activities toward more structured financial systems. It also evaluates how digital transactions influence access to credit, business growth opportunities, financial record creation, and participation in formal economic networks.

3.2 Research Objectives

The objectives of this study are:

- To examine the relationship between digital payment adoption and the formalization of informal economic activities.
- To analyze the influence of digital payments on financial inclusion, transaction transparency, and access to formal financial services.
- To identify major challenges affecting digital payment adoption among informal-sector participants.
- To explore strategies for promoting digital financial integration and sustainable economic formalization.

3.3 Research Questions

The study addresses the following research questions:

RQ1: How do digital payments contribute to the formalization of informal economies?

RQ2: Which digital payment factors have the strongest influence on financial inclusion and business integration?

RQ3: What challenges limit the adoption of digital payment systems among informal-sector participants?

4. Research Methodology

4.1 Research Design

This study adopts a conceptual quantitative research design to examine the relationship between digital payment adoption and economic formalization. The research framework evaluates important digital finance dimensions, including transaction transparency, financial inclusion, access to credit, business record creation, and formal economic participation.

A structured analytical approach is developed using simulated observations to demonstrate possible relationships between digital payment adoption and formalization outcomes. The simulated dataset is used only for conceptual evaluation and does not represent actual informal-sector survey data.

4.2 Data Source and Sample Framework

The study utilizes a simulated informal economy transformation framework representing small businesses, micro-enterprises, and self-employed individuals adopting digital payment systems. The framework considers indicators related to payment usage, financial access, business documentation, credit opportunities, and economic integration.

The selected variables represent commonly discussed factors in digital finance and development economics research. These indicators help evaluate how digital payments influence the movement of informal activities toward formal economic participation.

4.3 Research Variables and Analytical Techniques

The study considers digital payment adoption factors as independent variables and economic formalization outcomes as dependent indicators.

The major analytical dimensions include:

- Digital transaction adoption
- Financial record development
- Access to formal credit
- Business transparency improvement
- Economic participation enhancement

Descriptive statistical analysis is applied to evaluate the influence of digital payment factors on informal economy formalization. Comparative interpretation is used to identify major contributors toward digital economic integration.

4.4 Methodological Framework

Table 1: Research Methodology Framework

Research Component	Description
Research Approach	Conceptual quantitative analysis
Research Design	Digital payments and economic formalization framework

Research Component	Description
Data Type	Simulated informal-sector digital finance dataset
Study Variables	Digital payment adoption, financial inclusion, formalization indicators
Analytical Method	Descriptive statistical evaluation
Research Objective	Understanding digital payment contribution to economic formalization

5. Analysis

5.1 Influence of Digital Payments on Informal Economy Formalization

Digital payment systems have increasingly influenced the transition of informal economic activities toward more structured financial participation. The analysis indicates that electronic transactions improve financial visibility, create transaction records, and increase opportunities for informal businesses to connect with formal financial institutions.

The findings suggest that digital payments enable small enterprises and self-employed workers to establish financial histories, improve business credibility, and access services that were previously difficult to obtain. Digital transaction records can act as evidence of economic activity and support future financial opportunities.

5.2 Evaluation of Digital Payment Factors Supporting Formalization

The analysis evaluates major digital payment factors and their contribution toward informal economy formalization. The simulated findings indicate that transaction transparency, financial inclusion, and credit accessibility are significant contributors to economic integration.

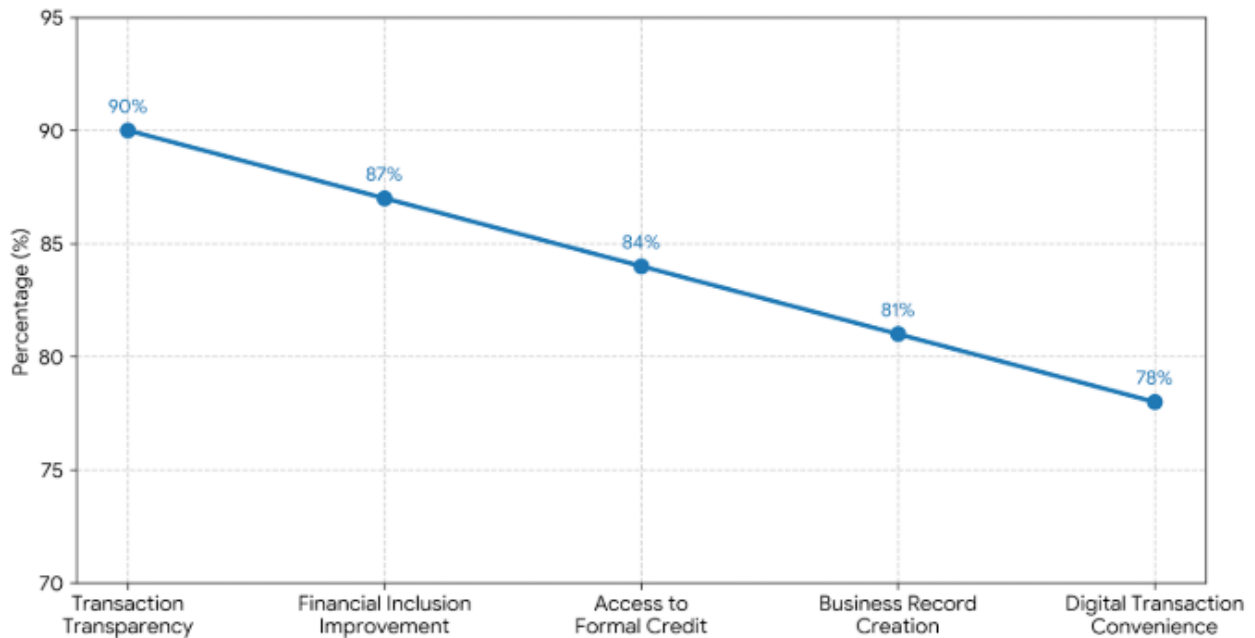
Table 2: Digital Payment Factors Influencing Economic Formalization

Digital Payment Factor	Formalization Contribution (%)
Transaction Transparency	90
Financial Inclusion Improvement	87
Access to Formal Credit	84
Business Record Creation	81
Digital Transaction Convenience	78

The findings indicate that transaction transparency represents the strongest contributor to economic formalization. Digital records improve financial visibility and encourage informal businesses to participate in structured economic systems.

Financial inclusion improvement also demonstrates significant influence because digital payments connect underserved entrepreneurs with formal banking and financial services.

Graph 1: Digital Payment Factors Supporting Economic Formalization



6. Challenges

6.1 Digital Literacy and Technology Adoption Barriers

One of the major challenges affecting digital payment adoption within informal economies is limited digital literacy among small business owners and self-employed workers. Many informal-sector participants may have limited knowledge regarding digital payment applications, online security practices, and electronic financial management.

The lack of technological confidence can reduce willingness to adopt digital payment systems, particularly among individuals who have traditionally relied on cash-based transactions. Digital education programs, user-friendly platforms, and accessible financial guidance are essential for improving adoption rates.

6.2 Limited Digital Infrastructure and Accessibility Issues

Reliable digital infrastructure is a fundamental requirement for successful digital payment adoption. In many regions, informal businesses operate in environments with limited internet connectivity, inadequate digital networks, or restricted access to smartphones and digital devices.

Infrastructure limitations can prevent small entrepreneurs from benefiting fully from electronic payment systems. Expanding affordable internet access, improving payment networks, and developing low-cost digital solutions are necessary steps for supporting economic formalization.

6.3 Cybersecurity Risks and Trust Concerns

Security concerns represent a significant challenge in digital payment adoption. Informal-sector participants may hesitate to shift from cash transactions due to concerns regarding fraud, unauthorized access, data privacy, and financial losses.

Building trust requires strong cybersecurity mechanisms, consumer protection policies, and awareness regarding safe digital payment practices. Financial institutions and technology providers must ensure that digital payment systems remain secure, transparent, and reliable.

6.4 Transaction Costs and Regulatory Challenges

Although digital payments can improve financial integration, transaction charges, service fees, and regulatory complexities may discourage adoption among small informal businesses. Entrepreneurs operating with limited profit margins may consider digital payment costs as an additional financial burden.

Supportive policies, affordable payment solutions, simplified regulations, and incentives for digital adoption can encourage informal businesses to participate in formal financial systems.

7. Discussion

7.1 Interpretation of Research Findings

The findings of this study demonstrate that digital payments can significantly contribute to the formalization of informal economies by improving financial visibility, increasing access to financial services, and creating opportunities for economic integration. The analysis indicates that transaction transparency, financial inclusion, credit accessibility, and business record development are important factors supporting formal participation.

The results suggest that digital payments provide informal businesses with mechanisms to establish financial identities and demonstrate economic activity. This can improve their ability to access formal credit, expand operations, and engage with regulated financial institutions.

However, the study highlights that digital payment adoption alone cannot guarantee economic formalization. Successful transition requires supportive financial ecosystems, digital education, reliable infrastructure, and policies that encourage inclusive participation.

7.2 Strategic Implications for Policymakers and Financial Institutions

The research findings provide important implications for governments, financial institutions, and technology providers. Policymakers should focus on developing inclusive digital payment ecosystems that reduce barriers for informal-sector participants and encourage voluntary transition toward formal economic systems.

Financial institutions can support this process by offering affordable digital payment solutions, simplified account access, and financial literacy programs. Customized services designed for small businesses and micro-entrepreneurs can increase trust and encourage broader adoption.

Technology providers should prioritize secure, simple, and accessible digital platforms that meet the practical requirements of informal businesses. Improving user experience and reducing technological complexity can accelerate digital financial integration.

7.3 Future Direction of Digital Financial Formalization

The future development of digital payment systems is expected to involve greater integration of mobile technologies, artificial intelligence, digital identity systems, and financial analytics. These innovations may further strengthen the connection between informal economic activities and formal financial structures.

Future research should examine the long-term effects of digital payments on business growth, income stability, taxation participation, and access to financial opportunities among informal-sector participants.

The discussion highlights that digital payments represent an important pathway toward economic formalization and inclusive growth. Their success depends on creating a balanced ecosystem that combines technology, financial accessibility, regulatory support, and user trust.

8. Conclusion

Digital payments have emerged as a powerful mechanism for supporting the formalization of informal economies by improving financial inclusion, increasing transaction transparency, and connecting small businesses with formal financial systems. This study examined the relationship between digital payment adoption and economic formalization by analysing the influence of transaction visibility, financial access, credit opportunities, business record creation, and digital financial participation. The findings indicate that digital payment systems can create pathways for informal-sector participants to achieve greater economic integration.

The analysis demonstrates that transaction transparency represents a major contributor to economic formalization because digital payment records provide evidence of business activity and improve financial credibility. Increased access to formal financial services and credit opportunities further strengthens the ability of small enterprises and self-employed individuals to expand their economic activities and participate in structured financial systems.

The study also identifies several challenges affecting digital payment adoption, including limited digital literacy, inadequate technological infrastructure, cybersecurity concerns, trust issues, transaction costs, and regulatory barriers. These challenges highlight the importance of developing inclusive digital ecosystems that combine technological accessibility with financial education, consumer protection, and supportive policy frameworks.

In conclusion, digital payments represent an important instrument for transforming informal economic activities into more transparent, connected, and financially integrated systems. Their effectiveness depends on creating accessible technologies, strengthening digital capabilities, ensuring secure transactions, and implementing policies that encourage inclusive participation. Future economic development strategies should focus on using digital finance as a pathway for improving financial inclusion, entrepreneurship opportunities, and sustainable formal economic growth.

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