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***Barriers and facilitators to transitioning of small
businesses (SMME's) from the second to the first
economy in South Africa***

By

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University of Pretoria, in partial fulfillment of the requirement for the degree

Of

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Abstract

This Research was undertaken to explore and better understand the perceptions of SMME owners, in South Africa, of the financial and non financial barriers and facilitators to the formalization/transitioning process. The study was motivated by the lack of data on the South African context of the barriers and facilitators of the formalization process. The conversion of enterprises from informal to formal concerns is not well researched and understood. In the absence of hard data, experienced observers and practitioners in the small business field express extreme skepticism about the efficacy of attempts to convert informal businesses to formal ones, (Bernstein, 2004).

The research was conducted, mostly in Alexandra township Johannesburg, by means of 20 in-depth, semi-structured, face to face interviews with SMME owners; 10 operating informally and 10 who formally were, but have since transitioned/formalized.

The resulting findings showed that lack of access to information on formalization and limited access to cash or credit are the major non financial and financial barriers respectively. Improved access to information on formalization is the major non financial facilitator and ability to access a bigger market plus increased access to cash or credit are the major financial facilitators. These findings also indicate that there may be a difference in the barriers and facilitators to formalization in South Africa as compared to what's reported internationally in the literature.



Declaration

I declare that this research project is my own work. It is submitted in partial fulfilment of the requirements for the degree of Masters of Business Administration at the Gordon Institute of Business Science, University of Pretoria. It has not been submitted before for any degree or examination in any other University.

Dr. Frank Aswani

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CHAPTER 1: INTRODUCTION AND PROBLEM

DEFINITION

1.1 Introduction

In this chapter, the research proposal and problem will be introduced. This chapter will also give us an overview of motivation of this whole research, why the research is being carried out and the relevance of this research to South Africa.

1.2 Introduction of Research Topic

The informal sector is arguably one of the highlights whenever economic development in the developing world is discussed. There are different schools of thought around the role of the informal sector in economic development; one school believes that it should be eliminated as it slows down economic development and fuels poverty. The other believes that it's here to stay and so should be harnessed for the benefits that it brings to the masses of the uneducated, unemployable citizens of the developing world who happen to also be victims of global forces and slow job creation in the formal sector.

Prof. Porter in a recent lecture at GIBS (July 07) stated that South Africa faces two major challenges; Labour issues and its high level of informality. South Africa currently has about 28% of its GDP in the informal economy (World Bank, 2007). Though this stands out as the lowest in Africa, it poses a major challenge

going forward in the Government's efforts to alleviate poverty and improve standards of living. SMME's (Small, medium and micro enterprises) also play a major role in the country's economic performance, productivity and as a source of livelihood and employment for many South Africans. Many of the SMME's play in the informal sector. This research will aim to better identify and understand what the financial and non financial barriers and facilitators are that prevent or facilitate the transitioning of SMME's from the second/informal to the first/formal economy.

1.3 Definition of the first and second economies

The second economy has, in the process of research, been defined using a plethora of names e.g. Shadow economy, informal sector, Grey economy, subterranean, clandestine, unreported, unrecorded, parallel and black (Feige,1989). In recent years, the Women in Informal Employment: Globalizing and Organizing (WIEGO) have in conjunction with ILO (International labour organization) broadened the earlier concept and definition of the informal sector to include not only enterprises that are not legally regulated but also employment relationships that are not legally regulated or protected (Chen,2002).

Portes and Haller (2005), describe the second economy as the enterprises that are not legally regulated by the institutions of society in a legal and social environment in which similar activities are regulated. Simply put, it's the economic activity that is neither taxed nor monitored by a government and is not included in the government's Gross National product (GNP). For the purposes of this research, Portes and Haller's definition will be used. In contrast, the first economy is that part

of economic activities that is formally recognized by the state, in other words the area in which it (i.e. the state) can intervene directly or indirectly.

1.4 The Informal sector and developing economies.

Hope (2004), states that by 2020, the informal sector in Africa will grow whereas the formal sector will stagnate thereby resulting in a contribution to GNP that will grow from under 50% in the 1980's to 66%. Chen, Jhabvala, and Lund (2001) cite that 83% and 93% of new jobs were created in the informal economy in Latin America and Africa respectively. This indicates that the trend of informalization is unlikely to be reversed. As the number of new entrants to the labour market in developing countries has grown and exceeded the number of jobs created in the formal sectors of the economy, the numbers of informal enterprises have also grown rapidly and are frequently the main source of employment. This informalization of the economy produces qualified benefits, on the one hand in that it helps to alleviate unemployment and poverty; on the other, however, informal jobs are often of low quality and may not constitute "decent work" as understood by the International labour organization (ILO, 2002).

Informal enterprises also operate outside of the government system of regulation, which restricts governments' ability to incorporate them in policies and strategies in pursuit of national socio-economic goals. The failure of informal operators to comply with regulations that protect employment, the environment and

consumers lowers the ceiling on the quality of their development and on their potential for growth and wealth accumulation (Nelson and De Bruin, 2005)

Devey, Skinner and Valodia (2006) state that the informal sector, based on South African reserve bank estimates, contributes about 7% – 12% of GDP, while Budlender, Buwembo and Shabalala (2001) estimate it to contribute 8% – 12% of GDP. In South Africa, the informal sector is dominated by men (57.9%) and by Blacks (89.7%). The retail and wholesale trade disproportionately dominate the South African informal economy. There's also a close correlation between being poor and working the informal economy with 51% of those working in the informal enterprises earning R500 or less and 92% earning less than R2500 (Devey, Skinner and Valodia, 2006).

Informality is one of the defining characteristics of economic activity in Latin America. The informal sector, which is made up primarily of micro and small enterprises, is no longer seen as a shadowy and unproductive sector of the economy, but rather as an integral part of the economic productivity of the region. Nevertheless, there are convincing arguments that an increased rate of formalization among these enterprises would bring significant benefits for the micro entrepreneurs, their employees and society in general (Jansson and Chalmers, 2001). Ayyagari, Beck and Demirguc-kunt, (2003), indicate that economic growth in poor countries is accompanied by a more proportional growth in the formal small and medium enterprise sector (SMME).

When informal resources are examined, such as the potential value of land, the domestic assets that can be tapped are significantly larger than the cumulative

FDI (Foreign Direct Investments) or private portfolio flows. Estimates of the informal assets in developing countries range as high as \$9.4 trillion, many multiples of cumulative portfolio flows or of FDI flows to developing countries over the past 15 years. Recent work in Egypt for example, concludes that the country has a large and vibrant extra legal economy that employs 8 million people (40% of the workforce) and has assets of almost \$250 billion, 30 times the market value of the Cairo stock exchange (Martin and Zedillo, 2004)

The World Bank views the development of the SMME sector as a core element to foster economic growth employment and poverty alleviation. There's also growing recognition of the role that SMME's play in sustained global and regional economic recovery. However, there's little systematic research in this area backing the various policies in support of SMME's primarily due to lack of data. SMME's can be engines of job creation and seedbeds of innovation and entrepreneurship. But in many poor countries, SMME's are marginal in the domestic ecosystem. Many operate outside the legal formal system, contributing to widespread informality and low productivity. They lack access to long term capital, the base on which companies are build on (Martin and Zedillo, 2001).

1.5 SMME's in South Africa

Bernstein (2004) estimates there to be 2.5m enterprises in South Africa as of 1999, of which small enterprises (SMME) sector represents about 99%. It's estimated that 45% of working South Africans are employed in the small enterprise

sector, which represents 4.8m working people. As for contribution to GDP, it's estimated that SMME's account for 50% of GDP (Malagas, 2002). Approximately 50% of the SMME sector consists of survivalist enterprises (i.e. have no paid employees, income generated is below poverty line, informal in status i.e. unregistered and not paying tax), the number of which is said to have increased by 74% since 1999 (Bernstein, 2004). Berry, Blottnitz, Cassim, Kesper, Rajaratnam and Van Seventer (2002) state that despite their high contribution, survivalist enterprises are showing little or no prospects of growth, which could further lead to decreased contribution to South Africa's economic growth. Of the non survivalist entrepreneurs, African non survivalist entrepreneurs accounted for only 0.54% of all economically active persons in the country compared to 6.4% white and 3.8% Indians However, lack of Africans in the more complex SMME's doesn't mean that they lack an entrepreneurial spirit, (Bernstein, 2004).

1.6 Relevance of this topic to the South African business environment.

Based on the preceding discussions, the relevance of this topic to the South African businesses environment is multifactorial. Firstly, as businesses transition into the first economy, they get more recognized by various institutions e.g. banks and in the process access credit for investments thereby increasing their chances of expanding their top and bottom lines. They can therefore hire more people, under the right employment terms and conditions and develop their employees

leading to a general reduction in unemployment and skills improvement. All these benefits could have far reaching implications on society in general e.g. general skills improvement, reduction of crime and improvement of socio-economic status. Secondly, the more the numbers of businesses that operate under the formal framework, the more taxes the government can collect and in the process offer better services e.g. maintenance for roads and security that in turn keep the costs of doing business low and encourages investments. In their formal status, the businesses can also increase their chances of getting advice and assistance through government programs and other relevant bodies. Thirdly, as more businesses come into the tax bracket, it will level out the competitive playing field by eliminating the unfair cost advantages that the non tax paying firms currently possess.

1.7. Motivation for research

Addressing parliament in 2004, President Thabo Mbeki remarked that the second economy constituted the structural manifestation of poverty, underdevelopment and marginalization in South Africa. It's where South Africa's jobless (some 30% of the national workforce) try to make ends meet (African Business, 2005). In South Africa, the second economy has become an important element in the government's development of policy and plans to combat poverty. Whereas the first economy is modern, and integrated with the global economy and in the process producing the bulk of the country's wealth, the second economy is

underdeveloped, has a large population and is isolated from the first and global economies. This dualism can be attributed to two main factors; South Africa's history up to 1994 and the changes in the global economic environment in the second half of the 20th century (Kirsten, Aliber, Maharajh, Nhlapo-Hlope and Nkoane, 2006).)

In the 2004 state of the Nation Speech, President Mbeki argues that the *"...core of our response to all these challenges is the struggle against poverty and underdevelopment, which rests of three pillars. These are: Encouraging the growth and development of the first economy, increasing its possibility to create Jobs; implementing our program to address the challenges of the second economy; and building a social security net to meet the objective of poverty alleviation"*.

The ANC elaborated on the notion of a dual economy by characterizing the second economy as *"....The first and second economies in our country are separated from each other by a structural fault.... Accordingly, what we now have is a reality...of a "mainly informal, marginalized, unskilled economy, populated by the unemployed and those unemployable in the formal sector". The second economy is caught in the "poverty trap". It is therefore unable to generate the internal savings that would enable it to achieve the high rates of investments it needs. Accordingly, on its own, it is unable to attain rates of growth that would ultimately end its condition of underdevelopment."* (ANC Today, 26 November 2004).

Kirsten *et al* (2006) cite that it is clear that the first economy alone will not reduce poverty quickly on a massive scale. Thus the limited short and medium

term potential of the first economy to alleviate poverty is a principal argument in favor of robust interventions in what we now call the second economy

In a 5-year period, the informal sector in South Africa grew from 1 million jobs to 2.7million jobs (Triegaardt, 2006). Whereas the South African economic progress has seen the country enjoy positive GDP growth for some 20 or so quarters, poverty rates in the country have risen from 15.5% in 1995 to 30.5% in 2002 (African Business, Nov2005). In its 2005 annual country assessment, the International Monetary Fund (IMF) commended South Africa for the remarkable economic progress achieved since 1994 but at the same time notes that serious economic challenges remain: persistent high unemployment, poverty, large wealth disparities and high incidence of HIV/AIDS (IMF, 2005).

The Mckinsey quarterly (2007) states that in Brazil, as in most other developing economies, large numbers of grey market (second economy) companies in many sectors evade taxes and social obligations to their workers, ignore quality and safety regulations or infringe upon copyrights. By so doing, they gain cost advantages that allow them to compete against more efficient law abiding businesses. Honest, law-abiding companies lose market share and thus have less money to invest in technology and other productivity enhancing measures.

1.8. Research objectives

The conversion of enterprises from informal to formal concerns is not well researched and understood. In the absence of hard data, experienced observers

and practitioners in the small business field express extreme skepticism about the efficacy of attempts to convert informal businesses to formal ones, (Bernstein, 2004). The aim of this study is to get qualitative data on the barriers that are preventing or slowing down transitioning of small businesses from the second to the first economy and do the same for the facilitators/motivators that could enable or have enabled successfully transitioning.

The findings of this study could be useful to Government departments that are responsible for driving the formalization of the second economy and to SMME owners currently operating in the second economy who wish to formalize/transition their businesses to the first economy

1.9. Research problem

Against the background of the significance of the formalization of the second economy to the future of south Africa as stated above by President Mbeki, and the fact that the conversion of enterprises from informal to formal concerns is not well researched and understood (Bernstein, 2004), the research problem investigated in this study is “What are the key financial and non-financial barriers and facilitators in the transitioning of small businesses from the second to the first economy? This will be done by collecting views of SMME owners in the informal/second economy and also those who were in the second economy but have since made the transition to the first/formal economy.

CHAPTER 2 – LITERATURE REVIEW

2.1. Introduction

As South Africa celebrates the dawn of its second decade of multi-racial democracy, its significance as a player in the global and African economy takes closer scrutiny. Its role as Africa's largest economy is highlighted in view of the global expectation's that South Africa will be a yardstick of the frontline pace of Africa's development. South Africa's entry into the global economy also comes with the expected comparison of South Africa to the BRIC (Brazil, Russia, India and China) countries as part of the cluster of developing countries that are at the fore of economic development and modernization.

South Africa, however, attracts a special interest that arises from its apartheid legacy. The ills of apartheid are well and clearly understood and its ramifications still felt even more than ten years post its abolition. Part of the apartheid legacy is the high level of lack of skills, education and modern day opportunities amongst the previously disadvantaged and especially the black Africans. This has given a significant association of these previously disadvantaged people with the informal economy. Notwithstanding the effects of apartheid, it will be wrong to assume that the presence of the informal economy in South Africa is entirely due to apartheid. Other factors also contribute to its presence and will be investigated in this section.

In this section, the investigator reviews existing literature against the research questions to try and understand what the current global thinking is around the key

research areas and where possible, get a south African context of the issues highlighted.

2.2. Informal sectors and economic development in developing countries

Shadow or underground economic activity is a fact of life around the world and there are strong indications that it's increasing. Most societies attempt to control these activities through various punitive measures or through education rather than through reforms of the tax and social systems which could improve the dynamics of the official economy (Schneider and Enste, 2000). Hope (2001), states that by 2020, the informal sector in Africa will grow whereas the formal sector will stagnate thereby resulting in a contribution to GNP that will grow from under 50% in the 1980's to 66%. Devey, Skinner and Valodia (2006) state that it's now widely accepted that informal employment in South Africa has grown since the political transition but that the growth has declined over the years. Employment in the informal sector in South Africa is concentrated in trade with just under half of all informal workers located in this sector (47.1%) i.e. trade. Ishengoma and Kappel (2006) state that majority of informal sector (IS) enterprises target the low income market because it's associated with low entry barriers.

The Russian federation, Sub-Sahara Africa, Latin America and Central Asia have the highest levels of informality; often more than 50% of GDP and their informal sectors have seen the greatest increase since 1990. Informality is

however growing fast in the Middle East, North Africa and South Asia according to the World Bank (Farrell, 2006). Devey, Skinner and Valodia (2006) state that the informal sector, based on South African reserve bank estimates, contributes about 7% – 12% of GDP, while Budlender, Buwembo and Shabalala (2001) estimate it to contribute 8% – 12% of GDP.

Schneider (2000) states the most important causes of the increase of the informal economy as being the rise of the burden of taxes and social security contributions, increased regulations in the official economy especially labour markets, forced reduction of weekly working time, early retirement, unemployment and the decline in civil virtue and loyalty towards public institutions combined with declining tax morale.

Rodrik (2000) states that the cause for the high unemployment in South Africa is that the prevailing South African wages are too high compared to real wages that would clear labour markets at lower levels of unemployment. The same sentiments are echoed by Prof. Michael Porter in his recent lecture at GIBS, July 2007. Prof. Porter states that for a country with 28% unemployment, South Africa's minimum wage is too high and may increase unemployment and in the process drive informality. South Africa's non-mineral tradables (including manufacturing) are intensive in low skilled labour compared to services. The relative shrinkage of manufacturing (along with economy wide skill upgrading) has entailed a collapse in demand for relatively unskilled workers. Rodrik (2006) further states that the existing system of social grants presumably sets a higher reservation wage level in

south Africa than in comparable countries, acting as a deterrent to low productivity informal activities (e.g. street peddling).

Policy makers should be concerned about the rise in the informal economy for the following reasons; it can be seen as the reaction of individuals who feel overburdened by the state and who choose the “exit option” rather than “voice option”. It may also cause severe difficulties for politicians because official indicators on unemployment, labour force, income and consumption are unreliable. The effects of a growing informal economy on the official one must also be considered; on one hand it may draw workers away from the formal economy and create competition for the formal firms. On the other, at least two thirds of the income earned in the shadow economy is immediately spent in the formal economy thus having a positive effect on the formal economy.

Nevin (2005) states that in South Africa the second economy has become an important element in the government’s development policy and plans to combat poverty. This is also true for developing countries whose wealth is unequally divided amongst the rich and very poor. The Southern Africa Regional Poverty Network (SARPN) identifies the second economy as being underdeveloped, isolated from the first and global economies, contains a large percentage of people including the urban and rural poor and contributes little to the country’s wealth.

It’s now widely accepted that the actual transformation of the second economy will be a long term goal as the difficulty of undoing the legacy of the “two economies” has been underestimated. The immediate task is to intervene broadly and coherently in the second economy to assist and encourage as many people as

possible to realize their economic potential. The real challenge for the government is to help the second economy obtain finance and market related information on how and where to market their services. She states that the inability to borrow against property or future earnings prevent the poor from investing in entrepreneurial ventures and assets for wealth creation such as education (Kirsten *et al*, 2006).

The growth and development strategies for the second economy in South Africa include rural development and urban renewal, development of small and medium enterprises and cooperatives, Black economic empowerment, expansion of micro-credit, an expanded public works program, learnerships and internships for the unemployed, improvement of the education system to provide useful skills and the training and deployment of community development workers (Nevin, 2005). President Mbeki when being interviewed on SABC also talked about the Expanded Public Works Program (EPWP) as one of the second economy interventions (SA GOV 2006). This program is not just about Public works. People working in these projects will also be trained as they work on the various projects so that they are able to work in the construction industry or even set themselves up as independent small businesses. The IMF applauds these efforts but notes that these could be bolstered by labour market reforms and further trade liberalization. Rogerson (2004) cites that with the existing government, SMME programs have largely been biased towards the group of medium and small-sized enterprises and, to a large extent, have by-passed micro-enterprises and the informal economy.

In a view that's pro-informal economies, Asea (1996) states that the underground economy adds to the economy a dynamic and entrepreneurial spirit and can lead to more competition, higher efficiency and limits on government activities. The informal sector may also contribute to creation of markets, increase in financial resources, enhance entrepreneurship and transform the legal, social and economic institutions necessary for accumulation. Schneider (1998) shows that over 66% of shadow economy earnings are immediately spent in the formal economy with positive effects for economic growth and for indirect tax revenues.

The informal sector can also be looked upon as both the casualty and the cure to many ill effects of globalization. Firstly, informal sector absorbs the victims of globalization – displaced workers, forced retirees, educated unemployed etc. While the informal sector cannot offer jobs, it can offer income opportunities. In this sense, the informal sector is in itself a safety net. Secondly the informal sector cushions the impact of the globalization of the surviving formal sector. The informal sector provides “wage goods” to the formal sector that reduce the impact of high inflation and real income fluctuation of real wage earners. The informal sector supplies cheap labour, services and goods to the formal sector. It also creates the venue for the formal sector to gain added income earning opportunities. Thirdly, the informal sector expands the domestic market, spreads purchasing power amongst the poor and brings the products of the formal sector into the poorest segments of society thus contributing to the health of the formal sector. Fourthly, the informal sector covers up what the government has failed to provide in terms of basic services. Informal shelter, day care centers, herbal medication, small group

credit assistance, waste picking and recycling, all reflect the fundamental inadequacies of government that are filled up by the informal sector (Yuzon, 2005).

Opportunity costs of informality include limited access to public services e.g. legal services, avoiding expansion due to desire to want to stay off the radar screen, limited access to financial and business development services and limited opportunity to cooperate and learn from formal enterprises. Schneider (2000) states that an increase in the shadow economy can lead to decreased state revenues, which in turn reduces the quality and quantity of publicly provided goods and services leading to higher tax rates in the official sector. This leads to an increased incentive to be in the shadow economy.

Loazy (1996) finds empirical evidence for Latin American countries that if the shadow economy increases by 1 percentage points (of GDP) – *ceteris paribus* – the growth rate of the official real GDP per capita decreases by 1.2% points. The negative impact of informal sector activities on economic growth is not broadly accepted; For example, the informal sector may not pay taxes but it pays penalties which are not used to finance public services.

Is formalization the solution? Given the current business and economic environment in developing countries the opportunity costs of informality seem to be much lower than the cost of operating formally. This is based on the premise that even SMME's with a higher degree of formality still face the same obstacles as those with a higher level of informality. On the other hand, the cost of operating formally is very high for formal, medium firms (Weder, 2003). This discourages SMME's to grow and increase their formality.

2.3. Developed economies and the informal sector

Spain's experience in the 1990's, shows that informality can be curbed. The government reduced corporate taxes and created a new agency to fight evasion. It also streamlined labour laws and lowered taxes on employment. The result was a mass job creation in the formal economy; unemployment fell by 40% over the next six years. What is more, tax revenues collected from small companies went up by more than 75%, even though corporate tax rates had come down. Governments can use their revenues gained from tackling informality to help prepare workers who lose jobs for new work in the formal economy.

The experience of countries that are successfully reducing their informal economies suggest a need for a three pronged approach: reducing the burden of formality by reforming the tax system and labour laws, improving the enforcement of laws and regulations and creating a culture of formality by raising the popular awareness about the gray market's harmful effects on economic development; Some measures should be sector specific and others should broadly address structural problems across sectors (The Mckinsey Quarterly, 2007)

2.4. Key drivers of the informal sector

Since the informal sector was formally recognized by the ILO in Kenya in 1972 (Bangasser, 2000), it has been a major point of discussion when it comes to economic development in the developing world. In many parts of the world, its size has shrunk but in Africa it's remained as a significant part of the GDP and is

projected to grow in the days to come. Below are various factors that have stimulated the growth of the informal sector.

The majority of analysts agree that economic recession is one of the foremost causes of the development and tenacity of the informal sector. Stagnation, unemployment and depreciation of capital stimulate participation in informal activities. Broadly, these reasons can be divided into economic reasons e.g. unemployment, inflexible formal labour market, declining real price of capital, and a high cost of formal production and non economic reasons e.g. need for greater flexibility and work satisfaction, a complete use of their professional qualifications and increased leisure time (Gerxhani, 1999).

Most of the informal self employed workers said they chose their occupations based on individual needs (desire for greater flexibility and independence) and skills. Many women, especially those married with children, prefer self employment over formal wage earner jobs to better balance work and family responsibilities (World Bank, 2007). In most OECD countries, unemployment is to a large extent caused by the high total labour costs which can be seen as a cause for the increase in the shadow economy (Schneider and Ernst, 2000).

Ligthelm (2003) cites that, in South Africa, the emergence of the informal sector is largely attributed to the divergence between the growth in especially the urban population and employment growth in the formal sector. Job creation in the formal sector frequently occurs at a far lower rate than the growth in the labour force. The shortage of productive employment opportunities therefore compels people to fend for themselves.

The need of people with limited disposable income to attend to their daily needs e.g. food, clothing etc generates a very significant demand for a variety of products and services that can be supplied by informal enterprises e.g. taxis and motor repairs that are often more affordable than those supplied by the formal sector and their type and quality more appropriate (Bugnicourt, 2000).

Kirsten *et al* (2006) quote unemployment as another major contributor to informality. Between 1995 and 2002, the working age of South Africa grew by about 2.2% per year, while the economically active populations increased by about 4% per year, implying a massive increase in labour force participation. Be it as it may, over this period the number of employed people increased by only one third as much as the economically active population with a result that an ever large number of people and even greater share of the labour force were unemployed.

Ishengoma and Kappel (2006) also add that decline in economic performance or non pro-poor economic growth, rural urban migration, Structural adjustment programs (SAP's) and disintegration of production and integration of trade as factors that drive the establishment and growth of the informal sector. Globalization has led to disintegration of production and the integration of trade, whereby global buyers are outsourcing some of their operations to cost effective regions leading to retrenchments.

Ishengoma and Kappel (2006) further state that decline in economic growth rate leads to job losses due to need of firms to cut operating costs. Retrenched workers seek alternative sources of income which more often than not are informal businesses. However, improving economic growth rates do not necessarily result

in a growth of the formal sector unless the economic growth is pro-poor meaning it is accompanied by improvements in formal employment levels and income distribution. Latin America faced increasing unemployment in the 1990's despite economic recovery. SAP's have expanded the informal sector in the following manner; real wages in the formal sector have decreased, raising the cost of living, thus forcing household members (especially women) to engage in the informal sector to supplement income. Privatization of state enterprises has led to retrenchments and trade liberalization has exposed firms to global forces and those that have not been able to compete have closed down.

World Bank, (2007), state that informal employment can also expand during economic booms as a result of attractive business opportunities in the informal sector. During Mexico's economic expansions, the number of workers leaving the formal sector to become self employed or to accept an informal wage earning employment is comparable to the number of those who move from the informal to the formal sector. Gerxhani (1999) also states that entry into the informal sector is characterized by almost zero entry and exit costs.

Loazya (1997) adds that the informal sector arises when excessive taxes are imposed by a government that lacks the capability to enforce compliance. An excessive regulatory system makes the formal economy unattractive by imposing high entry costs to legality through license fees and registration requirements and high costs to remain legal through taxes, red tape and amongst other labour and environmental regulations. The complexity of the tax system affects the size of the shadow economy. A complex income tax schedule allows more legal tax

avoidance than a simple one by providing various tax exemptions and reductions (Schneider and Neck, 1993).

Johnson, Kaufman and Zoido-Lobaton (1998) show that smaller shadow economies appear in countries with higher tax revenues, if achieved by lower taxes, fewer laws and regulations and less corruption. These factors have to be in equilibrium.

Pozo (2006) however states that the notion that high tax rates (and hence large governments) increase underground activity is not supported by data derived from a cross country study by Friedrich Schneider (1999) covering 70 countries. There was a no relationship between a high tax rate and the size of the underground economy. E.g. the US has a higher than average tax rate but a very small informal economy.

Pozo (2006) further states that there's a positive correlation between the informal sector and perceptions of corruption. Where people have faith in their taxes not being swindled, they will pay and on the opposite evade taxes if they believe that their taxes will go into the officials' pockets.

Increase in regulation reduces individual choices in the formal economy and increase labour costs. Intensity of regulation is often measured by the number of laws and requirements such as licenses, labour market regulations, labour restrictions for foreigners and trade barriers. Regulations lead to increased labour costs in the official economy and since these can be passed onto the employees, they provide further incentive to work in the shadow economy. The enforcement of the regulation, rather than the extent of the regulation (mostly not enforced), is the

key factor for the burden levied on firms and individuals that drives them to the shadow economy. These findings show that governments should put more emphasis on reducing the density of regulations or at least on improving enforcement of laws and regulations, instead of increasing the number of regulations. Some governments may increase the laws so as to wield more power or may totally ignore efforts in reducing the informal economy since many voters gain from unofficial activities. Reduction of working week hours as was done in France may have the unintended consequences of freeing more time for people to work in the informal economy. (Schneider and Ernst, 2000).

Jansson and Chalmers (2001), state that in the US, the costs regulation represent about 2.75% to 5.50% of US GDP. On a per-employee basis, firms in the survey spent an average of about \$17,000 (excluding capital costs) on regulation compliance; the very smallest firms (1-4 employees) spend as much as \$32,000 per employee.

In Peru, the costs of legality (the difference between the costs of operating fully within the law and an informal enterprise) is between \$590 and \$1,231 per month for a small business (Tokman and Klein, 1996).

A similar study in Costa Rica found that a typical SMME (with 5 employees or less and annual sales of \$25,000) pays about \$3,600 in ongoing obligations including taxes. Entrepreneurs weigh the cost and benefits of formalization and formality and pursue the course that will maximize their material and personal well being. (Jansson and Chalmers, 2001).

Social welfare may provide a disincentive for individuals receiving welfare payments to even search for work in the official economy, since their overall income is higher if they receive these transfers while working in the informal economy (Schneider and Ernst, 2000) plus they may go undetected in the informal economy.

Loazya (1997) continues to say that, the state, as the institution that monitors the regulatory and enforcements systems and administers public services, plays a crucial role in the formation of informal economies. If the state officials or interest groups related to them profit in some way from the presence of the informal sector, they will create an environment that makes informality attractive or simply unavoidable.

In summary, the informal sector is seen as a source of income and survival for the many that engage in it. Any factors that put people in a position where they have to swim against the tides and outcomes of modern economic and socio-political trends in order for them to survive will precipitate growth in informal activities. These tides and outcomes include unemployment, depreciation of capital, low economic growth, increasing taxation and regulations, need for greater work flexibility and work life balance, lack of formal skills and education, increased population growth and especially urban population, low formal job creation, increased use of technology leading to reduced use on manpower and poor economic policies especially pro-poor policies.

2.5. Economic impact of the informal sector

The informal sector may have a positive or negative impact on the economic health of a country. Discussed below are different schools of thought on the benefits or negative effects of the informal sector.

Farrell (2006) argues that slow economic growth is one of the most significant impacts of the informal sector. She goes on to say that informality gives an unfair cost advantage to the law ignoring informal players and thus gives no incentive for the formal businesses to invest in productivity improvement. This means slower growth, fewer jobs, which then drives more people into the informal sector in a self reinforcing cycle.

On the other hand, policy makers in developing countries may feel that the slower economic growth brought about by the informal sector is a price worth paying for the jobs that the informal sector create as they do employ a lot of people; ILO estimates stand at more than 70% of workforce in the developing world works informally (Farrell, 2006)

Tustin (2003) estimates that of the R377.7 billion of retail sales in South Africa, more than a third (37.7% or R142.5 billion) was channeled through routes like spazas (small shops selling consumables), hawkers, mail order, vending machines, non retail establishments e.g. wholesalers and E-commerce channels.

In conclusion, there's a school of thought that considers the informal sector as a major bottleneck to economic growth citing that the informal sector firms enjoy an unfair cost advantage, over the formal sector firms. This is due to the fact that they have don't have to carry any formality related compliance and compulsory

costs e.g. taxes, license fees, professional body fees etc. Therefore, there's no incentive to the formal sector to invest in productivity improvement and growth.

On the other hand, some in developing countries may feel that the slower economic growth brought about by the informal sector is a price worth paying for the jobs that the sector creates and the livelihood it sustains.

2.6. Economic impact of formalization

The benefits of formalization can be felt across businesses, consumers and the government to varying degrees. This section will look at the impact of formalization across economies and stakeholders.

Jansson and Chalmers (2001) have grouped the economic impact and benefits of formalization into three groups: - (1) Benefits for Micro enterprises which include avoidance of government penalties, ability to expand business without fear of government intervention, ability to conclude legally enforceable agreements with suppliers and customers, access to trade fairs and export opportunities, access to limit personal liability and access to government support programs. (2) Benefits for Governments which include expanded tax base, increased knowledge of economic activity. (3) Benefits for consumers, employees and society e.g. improved income distribution, improved health and safety standards, economic growth due to increased investments levels and economic efficiency gains and enhanced coverage of the social security system.

In summary, as a result of formalization, SMME's benefit from an increased access to resources, greater market and reduced risk. Governments expand their tax base and more economic data and consumers have increased access to more & better paying jobs.

2.7. Financial Barriers to formalization

There are many constraints on entering the formal sector. The over-arching issue is one of the costs versus the benefits for the individual entrepreneur who has to choose between formal and informal operations. In most countries, it's costly to be formal (Unleashing entrepreneurship, 2004).

In developed countries, only about half of the tax revenue is paid by registered businesses with the rest by individuals contrary to the picture in developing countries where registered companies pay up a far greater share of taxes – about 80% - which creates a big incentive to hide in the informal sector. In Sweden, informal employment is growing because Sweden has the second highest labour taxes in the world (Farrell, 2006).

Loazya (1997) highlights the two kinds of costs that informal enterprises face namely penalties when the informal activity is detected and the inability of these enterprises to take full advantage of government provided goods and services. Penalties for informal activities are usually stiff: very often detected firms have to surrender a considerable part of their output or physical capital stock. De Soto (1989) finds that informal entrepreneurs pay between 10 to 15% of their gross

incomes in bribes to corrupt government officials , whereas formal entrepreneurs pay an average of only 1% of gross income in bribes (without counting bribes used to become formal). In order to avoid being caught, firms scale down the size of their informal operations. In the case of purely informal firms, the efforts to avoid detection prevent them from achieving economies of scale and from choosing an optimal capital-labour mix; this is so because larger and more physical, capital intensive firms are easier to detect. Since informal activities are illegal, informal businessmen cannot exercise full property rights over their capital and product. Therefore, contracts related to informal activities cannot be enforced through the judicial system, thus their value and usefulness is greatly diminished (Loazy, 1997).

It is not surprising that a survey of informal Mexican micro-firms (SMME's) reveals that nearly 75% of the micro-firms report the main reason for not registering with the authorities is that they are just too small to make it worth their while. In contrast, only 2, 8 and 4% of the surveyed firms, answer that the main reason is the high costs, time required to register or the high costs of operating a registered business respectively. The same appears to be true for the Dominican Republic. In most cases, the degree of formality increases with firm size, suggesting that as firms grow, their demand for the services associated with formal institutions increases as does the probability of detection by the authorities (World Bank, 2007).

Ishengoma and Kappel (2006) state that financial costs of formalization can be categorized in form of entry costs which include all you licenses,

registration some upfront bribery. There are also formal operating costs which include compliance costs e.g. filling out government forms, taxes forms, business administration and labour regulations amongst others. Financial costs of entry into the formal sector, excluding required modifications in the business premises are estimated at an average of ten percent of annual profits in other Latin American countries (Tokman, 1992). These costs rise with any increased need of modification.

De Soto (1989), also talks about the financial costs of staying formal. In a sample of 50 small manufacturing firms, the costs of staying formal represented an average of 348% of after tax profits. Loazy (1997) states that costs of staying formal can be divided into three broad categories; taxes, regulations and bureaucratic requirements. Regulations include e.g. environmental protection, allocation of imported inputs & workers' welfare. Of all the regulations, those related to workers welfare are the most restrictive and costly in underdeveloped countries and in many developed countries (e.g. in South Africa, this could be the lengthy processes of dismissal plus the minimum wage). These include indemnities, health insurance, fringe benefits and wages. Portes, Castells and Benton (1989) argue that "the best known economic effect of the informalization process is to reduce the costs of labour substantially" costs which are mostly due to "indirect wages" such as benefits and social security contributions.

Torkman (1992) writes that for small firms in Latin America, the additional costs related to labour regulations are the most important components of the permanent costs of labour. He further reports that such regulations increase labour

costs by an average of around 20% which is equally divided between benefits and social security contributing. Poapongsakorn and Tangkitvanich (2000) estimates that informal firms in Thailand, by ignoring labour protection laws, save about 13 – 22% of labour wages.

In South Africa, Schoombee (2003) states that lack of access to formal bank credit is one of the important problems faced by South African micro-entrepreneurs in the informal sector. Although the government has addressed these issues, private banks are still not interested in serving micro-enterprises. Ishengoma and Kappel (2006) state that in developing countries, majority of SMME's lack access to formal financial services. Between 1995 and 2004, only 9% of informal firms in Jamaica, Nigeria and Tunisia had access to bank loans. The number stands at 4% in Uganda. In Nigeria, funds offered by micro finance institutions (MFI'S) were more relevant to the subsistence the SMME owner but not high enough for profitable investments. In Tanzania, it appears to be more expensive to borrow from MFI'S than from formal institutions.

In summary, a major financial consideration in the formalization process for SMME owners is the cost-benefit analysis of the formalization decision. There are, broadly, costs of entry into the formal sector e.g. licenses fees, registration costs and bribery costs and then there are costs of staying formal e.g. regulatory costs, compliance costs, taxes etc. These have to be weighed against the financial and non financial benefits of formalization.

2.8. Non-financial barriers to formalization

Lack of access to financial resources is more often than not perceived as the major barrier to formalization. However less weight is given to the non financial barriers to formalization which are discussed in the following section.

Farrell (2006) states that informal businesses, even large ones choose to stay that way if there's no change in the factors that generally drive them e.g. high corporate taxes and the bureaucratic burden of operating informally.

The costs of obeying the law also encourage informalization. For example, in Brazil where the informal economy represents 40% of GDP and half of urban employment, it takes 152 days to register a business – three times the world average. It takes 71 days in India, 6 in Singapore and 3 years to close an insolvent business in Vietnam. Given the costs of obeying the law, who wouldn't operate informally if they could get away with it? In countries with large informal sectors, there tends to be few tax collectors, who rarely prosecute and the judicial and law enforcement systems are inefficient. Many such countries are given to granting tax amnesties to coax businesses into the formal fold (as South Africa recently did). However, these just give the informal businesses an incentive to wait until the next one, rather than become regular tax payers. Turkey had 10 tax amnesties in the 40 years before 2003, but its informal sector didn't get any smaller (Farrell, 2006)

Kirsten *et al* (2006) states that other barriers include having to pay tax, being accountable to tax laws and policies as well as the relatively onerous requirements of registering a business.

Pozo (2006) says that the prevalence of corruption is more likely to affect both illicit and informal economic activity. Corruption and its impact on social morale contribute to the demise of respect for government, a disregard for laws and regulations and the rise of underground activity. More over, a corrupt police force and government officials will make enforcement against the illicit and informal productions of goods and services less.

Ishengoma and Kappel (2006) highlight that limited human capital/skills, utilization of obsolete technology, poor location of businesses, limited access to markets and business support services and lack of incentives for operating in the formal sector as other barriers to formalization. Limited links between small informal firms and larger formal firms, especially in manufacturing where there's a huge reliance on exchange of information and skills with the formal sector, leads to low competency within the informal firms. For example only 7% of informal businesses in Nigeria, and 10% to 20% in Algeria, Tunisia, Thailand, Ecuador and Jamaica had access to public procurement orders. Their informality also disadvantages the informal firms when it comes to contract negotiating and more likely to be exploited.

Job satisfaction within the informal sector is another consideration. On average, independent workers, either self employed or micro-enterprise owners in countries in Latin America and the Caribbean in which data was available, reported levels of welfare or job satisfaction similar to those they would have obtained if they held formal jobs for which they are qualified. However, one third of

self employed workers (more than half in Colombia) report to be there unwillingly and would prefer a formal wage earning job. (World Bank, 2007).

In conclusion non financial barriers to formalization include bureaucratic regulatory procedures e.g. lengthy registrations of businesses, poor law enforcement, corruption and limited human skills. Contrary to popular belief, there's also a level of job satisfaction that may discourage formalization and especially where people are seeking a better work life balance or where they enjoy more flexibility and or specialization. However, little work has been done to crystallize the South African situation.

2.9. Financial facilitators to formalization

The fear of incurring costs related to being informal is as good an incentive as the benefits acquired from formality, in stimulating the formalization process.

Avoiding costs of being informal is a good incentive to formalize. Ishengoma and Kappel (2006) state that operating within the IS has its own costs e.g. Penalties and corruption. In Peru, 10% to 15% of an enterprises gross income goes towards bribes while formal firms pay about 1% (De Soto, 1992). In transition economies, informal firms can incur bribes of up to 20% of their revenue (Djankov *et al*, 2002). When government officials benefit from the formalization process of informal enterprises (for example by receiving bribes), they may in fact retard the formalization process (Loazya, 1997).

The costs of capital in the informal sector can be quite high. De Soto (1989) points out that in Lima in 1985, the nominal borrowing rate for informal firms was 22% monthly, whereas it was 4.9% for formal firms of comparable size. The high costs of capital could limit any expansion efforts.

In summary, the desire to avoid costs associated with corrupt government officials in the informal sector and the lower costs of credit in the formal sector are good enough financial facilitators to drive formalization.

2.10 Non-financial facilitators to formalization

Ishengoma and Kappel (2006) state that the desire and need for growth comes with certain expectations. For example, one would need access to skilled labour and capital and these could both be inputs into the formalization process or facilitators of the process. Having access to legal advice also helps the firms to be able to draw up and formalize contracts that would protect them.

The line of business may also be more helpful in facilitating formalization based on standards and kinds of products or services produced. For example, in manufacturing, Ishengoma and Kappel (2006) state that there may be certain standards that need to be met and these will mean that most likely the enterprise will have skilled labour and be formal. On the other hand, some textiles industries may well operate from homes and have no such demands. The knowledge of anticipated benefits would also help the process. ILO (2003) found that some

employers and employees in the IS are ignorant of working and employment conditions

Where there is a high level of enforcements exercised by governments with inspections and sanctions (penalties or threats) being frequently made, the majority of enterprises tend to comply with regulations. This enables them to increase their returns (and level out the competitive landscape) (Ishengoma and Kappel, 2006)

De Soto (2001) argues that property rights have to grow from bottom up and this needs to be encouraged and taken up by governments as massive informality develops when the law fails to coincide with the way people live and work. The government of Sri Lanka has acknowledged this and already started to set up land titling and to provide legal tenure to families for the land that they have lived and worked on (Becker, 2004). This provision of title deeds offers poor people the right to use their properties in efficient and legally secured market transactions.

On Business location, Morrison (1995) emphasizes that all businesses should have equal chances to operate in good locations provided they abide by the rules governing these localities. Tokman (2001) suggests that informal enterprises (e.g. street vendors) need to be provided with permanent places for their activities in accordance with municipal regulations. He adds that such places need to be well served by the public transport system in order to enhance their markets.

Promotion of informal-formal sector and multi-lateral linkages will help firms in the IS benefit from a reliable market, financial support, technology transfer and training and supervision (Ishengoma and Kappel, 2006). Measures which

governments may take to promote linkages include: first, the reservation of a significant percentage of public orders for those SMME's that comply with regulations. This may encourage formalization. Secondly to address the exploitative nature of the formal-IS linkages and to enhance the institutional environment in which they operate. Part of this could include cutting out the middlemen and linking the producers directly to the buyers as Sri Lanka is aiming to do with its farmers (Becker, 2004). A third suggestion from the author of this study is for the government to give preferential treatment to those firms that are supporting SMME's similar to what is being done with BEE where the formal firms earn "points". Firms can even be encouraged to transfer their skills to these SMME's or offer the employees of the SMME's learnership opportunities in order to improve workers' capabilities."

Loazya (1997) states that there's also need for access to public services e.g. legal services. Informal enterprises are poorly protected by the national security system and are thus subject to many crimes and high transaction costs related to high opportunism from business partners; a situation that may force them to trade with people they know, hence limited market growth and potential. One can therefore conclude that for them to grow, they must tap into the public services that would enable them to get legal recognition and protect.

In conclusion, the necessary non-financial requirements of formalization are key in the formalization process. These include skilled labour, one's line of business may determine one's cluster which may force formalization. The level of government enforcement, a good business location, improved property rights and

the desire to access legal and other government support services are other non financial facilitators.

2.11. Conclusion

In summary, the informal sector is seen as a source of income and survival for the many that engage in it. Various factors drive or keep people in the informal sector. These include unemployment, depreciation of capital, low economic growth, increasing taxation and regulations, need for greater work flexibility and work life balance, lack of formal skills and education, increased population growth and especially urban population, low formal job creation, increased use of technology leading to reduced use on manpower and poor economic policies especially pro-poor policies

There's a school of thought that considers the informal sector as a major bottleneck to economic growth citing that it gives the informal sector firms an unfair cost advantage due to the fact that they have don't have to carry any costs related to taxes and other regulatory fees and in the process give no incentive to the formal sector to invest in productivity improvement. On the other hand, some in developing countries may feel that the slower economic growth brought about by the informal sector is a price worth paying for the jobs that the sector creates. Statistics generally show that economic growth and development is correlated with a smaller informal sector.

In formalization, there are various stakeholder benefits. SMME's benefit from an increased access to resources, greater market and reduced risk.

Governments expand their tax base and access more economic data for proper policy creation and consumers have increased access to more & better paying jobs.

Non financial barriers to formalization include bureaucratic regulatory procedures e.g. lengthy registrations of businesses, poor law enforcement, corruption and limited human skills. Contrary to popular belief, there's also a level of job satisfaction that may discourage formalization and especially where people are seeking a better work life balance or where they enjoy more flexibility and or specialization. On the other hand, the desire to avoid costs associated with corrupt government officials in the informal sector and the lower costs of credit in the formal sector are good enough financial facilitators to drive formalization.

In the formalization process, the SMME owner must do a cost-benefit analysis of the formalization decision. There are, broadly, costs of entry into the formal sector e.g. licenses fees, registration costs and bribery costs and then there are costs of staying formal e.g. regulatory costs, compliance costs, taxes etc. These have to be weighed against the financial and non financial benefits of formalization

CHAPTER 3 – RESEARCH PROPOSITIONS

The purpose of this research is to explore the barriers and facilitators to small businesses in transitioning from the second to the first economy in South Africa.

The research will:-

- Establish the perceived financial barriers to transitioning from the second economy to the first economy.
- Establish the perceived non financial barriers to transitioning from the second economy to the first economy.
- Establish the perceived non financial facilitators that enable successful transitioning from the second to the first economy.
- Establish the perceived financial facilitators that enable successful transitioning from the second to the first economy.
- Establish whether the perceptions on the above questions (1-4) differ between SMME owners who have made the transition from those who haven't.

The following propositions have been derived from the literature review and they were tested to check for their suitability to the South African context.

- **Proposition 1:** Lack of access to affordable capital or credit is the major perceived financial barrier to transitioning from the second to the first economy in South Africa.

- **Proposition 2:** Lack of skills on how to access a bigger market will be the main perceived non financial barrier to transitioning from the second to the first economy.
- **Proposition 3:** Improved business capabilities to enable access to a bigger market will be the main perceived non financial facilitator for the transitioning of businesses from the second to the first economy.
- **Proposition 4:** Increased access to increased affordable cash or credit will be the main perceived financial facilitators.
- **Proposition 5:** SMME owners in the second economy do not have an appreciation of the benefits and facilitators of formalization.

CHAPTER 4. RESEARCH METHODOLOGY

4.1. Introduction

This section describes the methodology used during the field research to collate and collect data looking at the barriers and facilitators in the transitioning of small businesses from the second to the first economy.

4.2. Research Methodology

The research method used here is qualitative and exploratory in nature and was conducted in 2 phases. Phase 1 was a secondary literature review and phase 2 a primary, interview based research. Leedy (2001) recommends a qualitative design when a researcher is attempting to interpret a certain phenomenon. Daft (1993) states that qualitative research cannot be objective and the researcher who chooses to follow a qualitative method must be comfortable with ambiguity and a subjective view of the world and must also want a close interaction with the informants. He further states that qualitative research is concerned with meaning rather than the measurement of (organizational) phenomena.

This research methods involve capturing people's opinion's, feelings and practice, their experience and the kind of atmosphere and context in which they act and respond, then qualitative research methods are highly recommended (Wisker, 2001).

4.3. The semi- structured interview

Personal, face to face interviews were conducted with the selected interviewees. In the use of semi-structured interviews, the investigator has usually planned the interview with structure and specific questions and objectives. They are easier to prepare and manage. General rules and problem solving strategies involving the different concepts can be uncovered (www.scism.sbu.ac.uk/inmandw/tutorials/kaqu/qu8.htm).

Semi structured interviews manage to both address the need for comparable responses, i.e. there are the same questions being asked of each interviewee, and the need for the interview to be developed by the conversation between interviewer and interviewee, which is often rich and rewarding. With a semi-structured, open-ended interview there are a series of set questions to be asked and space for some divergence, with the interviewer then returning to the structured interview (Wisker, 2001).

Semi-Structured interviews were also better because they allowed the investigator to explain things that the interviewee does not understand or finds confusing. They are also useful because the investigator doesn't have to worry about biased samples and incomplete questionnaires. (www.sociology.org.uk/methsi.pdf). Due to the fact that the investigator asks the same questions, he can look for consistency and compare responses between respondents.

4.4. Population of relevance

The population of relevance for this study is the South African small and medium enterprise (SMME) business owners both in the informal and formal sector.

In this case, the investigator further introduced other criteria. The interviewees were intentionally selected from around the Gauteng region simply due to convenience of easier access to the investigator who is Gauteng based. They were also selected on their ability to speak the English language due to the researcher's inability to speak any of the local South African languages. The selected business owners also have to be permanent South African residents (especially those in the informal sector). This latter criterion is intentionally inserted to remove any bias created by illegal immigrants who may have very different reasons for staying informal

4.5. Unit of Analysis

The unit of analysis is the opinion of the SMME owner, both from the informal and formal sector.

No biases were made in terms of the kinds of businesses they did so long as they were socially and morally acceptable.

4.6. Sampling method and sample size

The sampling method used was judgment sampling, also known as purposive sampling. The investigator selects the sample based on his or her judgment about some appropriate characteristics required of the sample member (Zikmund, 2001). Purposive sampling is described as a non random selection of sampling units within the segment of the population with the most information on the characteristic of interest (Quarter and Barrios, 2006). The sample size was 10 SMME owners who are currently in the second economy and 10 who have made the transition from the second to the first economy.

4.7. Design of and Data collection instrument

The data collection instrument used by the investigator was a semi-structured interview schedule (see appendix 1) in face to face, semi-structured interviews which are ideal for exploratory research (Gillham, 2001). The aim of the interview schedule was to obtain information regarding the perceptions of small business owners on the barriers and facilitators to the formalization transition. The schedule was designed from the research questions and the literature review.

The interview schedule was preceded by an introductory message to the interviewees that explained the purpose of the interviews. The introductory message to the formal business owners was emailed or faxed to them and that for

the business owners in the informal sector was read out to them prior to the interviews. The purpose of this introductory message was to give context to the interviewees plus gain permission to access the interviewees and record the interviews. The introductory message was either faxed or emailed to the SMME owners in the formal sector and handed out personally to the SMME owners in the informal sector as many did not have access to faxes or email.

The questions in the schedule were structured as open ended questions so as to encourage the respondents to express their answers from their own perspective. It also provided an opportunity for the investigator to deeply explore various parts of the interview as was deemed necessary. The questionnaire was piloted across four people to ensure suitability to the task ahead of data collection.

4.8. Data collection

Qualitative data collection is dependent on the personal involvement of the researcher and qualitative researchers tend to select a few participants who can best shed light on the phenomenon under investigation (Leedy and Ormrod, 2001)

The selected interviewees, from the township of Alexandra in Johannesburg, were contacted by the investigator through a community contact who helped in both the selection process based on the criteria discussed in the population of relevance section above, plus he set up the respective interviews spread over an eight week period.

The interviews were conducted at the SMME owners' respective business premises. They were all recorded using digital voice recorders and lasted between 35 minutes and an hour.

4.9. Data Analysis

The data analysis technique used here was content analysis and frequency distribution.

Content analysis is a research technique for the objective, systematic and quantitative description of the manifest content of communication. Content analysis obtains data by observing and analyzing the content or message of reports, letters and the like. It involves systematic analysis, as well as observation, to identify the specific information content and characteristics of the messages (Zikmund, 2003, p. 248).

This technique measures the extent of emphasis or omission of emphasis on any analytical category. Investigating the frequency and appearance (or "roles") of women, blacks and other minorities in mass media is a research effort that utilizes content analysis (Zikmund, 2003, p. 248).

Once all the data was collected, common themes were drawn from the data to a point where new insights could be inferred or drawn into constructs or factors. The various factors were then further coded as either barriers or facilitators and also either financial or non-financial. The frequency distribution of the number of mentions per construct/factor, as recorded from the interviews, were then

consolidated under the key research headings i.e. either barriers or facilitators, financial or non financial. These were the rank ordered in descending order so as to identify the main barriers and facilitators, financial or non financial.

These factors were also further analyzed under either informal or formal SMME headings to get further insights into the similarities and differences between the perceptions of the two groups.

From this analysis, a final conclusion was reached clearly outlining the key financial and non financial barriers and facilitators.

4.10. Limitations of the research

- Small sample size
- Researcher does not speak any of the local South African languages (apart from English) and hence did struggle to communicate with potential interviewees who could not speak English. As a result of the sampling process being biased towards English speakers, some information lost in the translation of specific words and terminologies. However, this was minimized by the presence of a community contact who did some translations as need arose.
- The sampling technique is a non-probability technique that by its very nature means that the outcomes of the study can't be generalized.
- The population being Gauteng based may not be reflective of the whole of South Africa.

CHAPTER 5 - RESULTS

5.1 Introduction

This chapter will go into the details of the research findings and present the data in different possible ways so as to maximize the potential value of information extracted..

5.2 Interviewees

The spectrum of businesses interviewed in the sample of twenty can be seen in Table 1 below.

Table 1 – INTERVIEWEES LIST

Interviewees	Business	Formal	Informal
Philip	Car Upholstery		1
Kedibone	Catering		1
Khensani	Cleaning	1	
Ken	Construction	1	
David	Construction	1	
Tisetso	Drycleaning	1	
Samuel	Fruit & veg		1
Emily	Fruit & veg		1
Charles	Groceries	1	
Brenda	Haircare	1	
Terry	Open air spaza		1
Mathew	Public Phones	1	
Tshidi	Restaurant	1	
Linki	Spaza		1
Makosandile	Spaza		1
Edward	Spaza		1
Joseph	Spaza		1
Chris	Tuck shop	1	
Moeng	Tuck shop		1
Paulina	Upholstery	1	
Column Total		10	10
Grand Total			20

The sample used in this study was a total of twenty SMME owners, ten of whom were operating informally and the other ten were businesses that had transitioned from informal to formally registered businesses. The interviews were mainly focused on businesses operating the township of Alexandra in Johannesburg, South Africa

Please note that for confidentiality purposes, only the first names of the interviewees are listed above.

There were a total of 7 women in the group with 4 of them being formal. The data was collected through face to face interviews using an interview guideline with open ended questions (see appendix 1). The data was collected over an eight week period and on average, each interview lasted about forty five minutes. All the interviews were done at the interviewees' businesses premises and recorded into a digital voice recorder. The interviews were then typed out and the emerging factors crystallized and aggregated under the four broad sections as aligned to the interview guidelines. The four broad sections are financial barriers and facilitators and non financial barriers and facilitators. The factors, and their frequency distribution were then captured and rank ordered.

This being an exploratory study, content analysis and frequency distribution was the preferred method of analysis. Content analysis is an unobtrusive research technique that allows researchers to analyze relatively unstructured data in view of the meanings, symbolic qualities and expressive contents they have of the communicative roles they play in the lives of the data sources (Krippendorff, 2004)

Under the formal SMME group, it was found that this group was not fully homogenous and that there were actually two subsets; a fully formal subset and the semi-formal subset. The latter were fully registered businesses on paper but not in practice i.e. they were non-compliant in their operations. For example they were non-compliant on tax and labour law issues. In the formal group, there was an equal split between the two subsets and this was purely coincidental. The semi-formal subset was represented by a wide variety of businesses; dry cleaning, upholstery, groceries, a tuck shop and a hair saloon.

During the discussions in this chapter the use of the words “formal group” will reference the wider formal group i.e. those that are fully formal plus those that are semi-formal.

5.3 Overview of observed factors

In this section, in table 2 below, we shall take a look at the total number of different types of factors observed in the whole study. These results were arrived at after applying content analysis to the recorded interviews.

Table 2 - NUMBER OF OBSERVED FACTORS

	Barriers	Facilitators	Total
Financial	5	4	9
Non financial	6	12	18
Total	11	16	27

In total there were twenty seven factors raised by the twenty interviewees as seen in table 2, above. Of these, 67% (18/27) were non financial and 33% (9/27) were financial. This could be interpreted to mean that lack of or presence of financial related factors/issues is less of an issue than the non financial related factors/issues in the formalization process.

There were also more facilitators raised than were barriers, 16 vs. 11 respectively. This could be interpreted as meaning that there are more perceived possibilities by the interviewees than hurdles.

5.4 Frequency distribution of observed factors.

Table 3 below shows an overview of the detailed quantitative frequencies of factors observed in the whole study, both in the formal and the informal groups. It splits the data in table 2 into the two groups, pre consolidation.

Table 3 – FREQUENCY DISTRIBUTION OF FACTORS BETWEEN THE FORMAL AND INFORMAL GROUPS

	Barriers		Facilitators		Totals
	Formal	Informal	Formal	Informal	
Financial	11	7	11	13	42
Non financial	16	17	13	12	58
Total	27	24	24	25	100

Table 3, above summarizes the frequency of mentions as raised under the 27 factors above. (Please note that the 27 factors in table 2 were after the factors

were consolidated. The above table represents the unconsolidated numbers). There were a total of 100 mentions, table 3, of the 27 factors in table 2 above.

Broadly, there were more non-financial than financial mentions 58 vs. 42. Of the 42 financial related mentions, a slight majority, i.e. 22/42, were raised by the formal group. Of the non-financial barriers, there was an equal split of mentions between the formal and informal groups at 29 each.

On the issue of barriers and facilitator mentions as seen in table 3 above, there were a total of 51 barriers vs. 49 facilitators. Broadly the formal group had a higher number of barriers than the informal group, 27 vs. 24. The informal group had slightly more facilitators mentioned than the formal group, 25 vs. 24.

The major difference in table 3 is with the financial barriers where the formal group had more mentions than the informal group, 11 vs. 7. This could be interpreted as being linked to not only the financial barriers related to becoming formal but also those linked to staying formal e.g. annual fees, registration costs and compliance costs and hence the higher reporting within the formal than the informal group.

5.5 Formal SMME factors

As can be seen from table 4 below, this group had slightly more barriers raised than facilitators, 27 vs. 24 and more non-financial than financial factors, 30 vs. 21. One also observes that within the barriers, there are more non-financial factors than financial factors, 17 vs. 10. This could indicate that for these formal businesses, potentially, compliance to formalization regulations and expectations is a major issue in their challenge to stay formal.

Table 4 - FORMAL SMME'S FACTOR FREQUENCY

FORMAL SMME'S FACTOR FREQUENCY			
	Barriers	Facilitators	Total
Financial	10	11	21
Non financial	17	13	30
Total	27	24	51

Table 5 below goes into slightly more detail. It shows detailed factors, and their frequencies, as observed within the formal group. This table is a summary of both the fully formal and semi-formal groups, combined. The factors were rank ordered.

There were a total of 20 factors identified with a frequency of 51 mentions. These were distributed and rank ordered as shown in table 5 below. Looking at the factors, by frequency, ability to access a bigger market is the highest ranked, financial facilitator/motivator in the formalization process. Lack of access to cash to effectively access this market follows as the next highest ranked factor and is perceived as the highest ranking financial barrier.

An interesting observation is that there are 4 mentions against the “lack of access to formalization information”. This was mentioned as being both the difficulty in getting the right information, pre-formalization, to having the right information once you are formalized e.g. which businesses should pay VAT and which ones should not, need for one to have employee contracts, need to keep training records as a pre-requisite for some tenders etc.

Table 5 – FORMAL SMME FACTORS

FORMAL SMME'S FACTORS	FACILITATORS		BARRIERS		TOTALS
	FINANCIAL	NON FINANCIAL	FINANCIAL	NON FINANCIAL	
Access to bigger markets	8				8
Lack of access to cash			6		6
Complexity of registration requirements & process				5	5
Lack of access to formalization information				4	4
Lack of business management skills				3	3
Support from MNC business partners, Family & friends		3			3
Fear of the law/need to be compliant		3			3
Access to cash	3				3
Presence of technical skills		2			2
Document processing delays				2	2
Ease of registration		2			2
Costs of staying formal			2		2
Need for professional image		1			1
Lack of access to bigger markets			1		1
Lack of equipment				1	1
Access to formalization information		1			1
High costs of registration			1		1
Poor understanding of the benefits of formalization				1	1
Response to Government campaign		1			1
Revenue too small to pay tax				1	1
Totals	11	13	10	17	51

There were also complains of there being no government information services in Alexandra, close to the people. E.g. for one to register, one has to go to Pretoria.

The lack of business skills mentioned above is all about them realizing that, once formalized, they don't have the skills or capabilities to run a formal business and neither can most of them afford to outsource it e.g. filling out tax forms, keeping good financial records, interpreting the labour laws in relation to their workers etc.

We shall now look at a bit more detail into the two subsets that form the formal group above i.e. the fully formal and the semi-formal subsets.

5.6 Semi formal SMME subset factors

The section isolates the semi-formal businesses and looks at the factors related specifically to them. This group is formalized on paper but non compliant in practice.

Table 6 – SEMI-FORMAL SUBSET GROUP FACTOR FREQUENCY

SEMI-FORMAL SUBSET			
	Barriers	Facilitators	Total
Financial	6	5	11
Non financial	9	5	14
Total	15	10	25

From the factor overview on table 6, this group reported a much higher number of barriers than facilitators, 15 vs. 10 , and a higher number of non-financial than financial issues, 14 vs. 11. This could be linked to difficulty in

compliance and registration issues and costs. Table 7 below, shows the detailed factors and their frequencies, as observed within the semi-formal subset group.

Table 7 – SEMI-FORMAL SMME FACTORS

SEMI-FORMAL SMME'S FACTORS	FACILITATORS		BARRIERS		TOTALS
	FINANCIAL	NON FINANCIAL	FINANCIAL	NON FINANCIAL	
Access to bigger markets	4				4
Lack of access to cash			4		4
Lack of business management skills				2	2
Complexity of registration requirements				2	2
Costs of staying formal			2		2
Lack of access to formalization information				2	2
Support from MNC business partners, Family & friends		1			1
Presence of technical skills		1			1
Poor understanding of the benefits of formalization				1	1
Access to cash	1				1
Ease of registration		1			1
Response to Government campaign		1			1
Document processing delays				1	1
Revenue too small to pay tax				1	1
Fear of the law/need to be compliant		1			1
Totals	5	5	6	9	25

In their top 5 factors, this group raised only one facilitating factor (a financial one) i.e. the need for access to bigger markets, with a frequency of 4 mentions. The other four factors were all barriers in nature with 2 being financial and 2 non-

financial. Financial barriers had the most mentions as compared to the non financial barriers, 6 vs. 4. Of the financial barriers, the dominant was the lack of access to cash (4 mentions) and the other was the costs of staying formal (2 mentions). The other two non-financial barrier factors were complexity of the registration process and lack of business management skills e.g. keeping of financial records etc that each had 2 mentions.

5.7 Fully formal SMME subset factors

Table 8, below, introduces the fully formal subset group with a look at their factor frequencies.

Table 8 – FULLY FORMAL SUBSET GROUP FACTOR FREQUENCY

	Barriers	Facilitators	Total
Financial	4	6	10
Non financial	8	8	16
Total	12	14	26

Comparing the fully formal to the semi-formal subsets, i.e. tables 6 & 8, the following things become evident:-

There's a higher number in the perceived barriers mentioned from, 15 vs. 12, in the semi-formal subset vs. the fully formal subset. This increase is driven mainly by higher number of financial barriers, 8 vs. 6, specifically the lack of access to cash and the costs of staying formal. Other contributors to this difference are non-financial issues linked to either the formalization process or the need for skills needed to maintain a successful formal business e.g. book and record keeping, understanding tax and labour law requirements etc.

There's also a higher number of facilitating issues raised in the formal subset, 14 vs. 10, formal vs. Semi-formal. This is driven mainly by a higher number of non-financial facilitating issues in the formal group. The two main issues raised under non-financial facilitators are the support from formalized business partners e.g. MNC'S and or the presence and support from role models, either family or friends, who are themselves, running successful formal businesses.

Table 9 below, shows the detailed factors and their frequencies, as observed within the fully formal subset group.

Table 9 – FULLY FORMAL SUBSET FACTORS

FORMAL SMME'S	FACILITATORS		BARRIERS		TOTALS
	FINANCIAL	NON FINANCIAL	FINANCIAL	NON FINANCIAL	
FACTORS					
Access to bigger markets	4				4
Complexity of registration requirements & process				3	3
Lack of access of formalization information				2	2
Support from MNC business partners, Family & friends		2			2
Fear of the law/need to be compliant		2			2
Lack of access to cash			2		2
Access to cash	2				2
Lack of business skills				1	1
Need for professional image		1			1
Presence of technical skills		1			1
Document processing delays				1	1
Lack of access to bigger opportunities			1		1
Lack of equipment				1	1
Access to formalization information		1			1
Ease of registration		1			1
High costs of registration			1		1
Totals	6	8	4	8	26

As can be seen, the highest ranking factor is the need to access a bigger market as a financial facilitator/motivator to formalization with 4 mentions. The next two factors are non-financial barriers namely, complexity of the registration process and difficulty in accessing information on the formalization process. They had 3 and 2 mentions respectively.

It was interesting to note the 2 mentions of the “significance of support from MNC partners, friends and family” in the formalization process. In these cases, the interviewees either had role models in friends or family or were encouraged by their MNC business partners.

This group is also likely to be the more conscientious ones with 2 mentions of the need to be compliant as facilitating/motivating factors.

5.8 Informal SMME factors

Table 10 below outlines the detailed factors, and their frequencies, rank ordered, as identified within the informal SMME group. Once again, this was a group mainly of people in the retail trade with Spazas, tuck shops and fruit and vegetable grocery businesses accounting for about 8 out of the 10 interviewees i.e. 80%. 3 out of the 10, i.e. 30%, were women.

From the interviews, it was noted that this was also the group that had the least amount of leveraging, if any, in their business. They were the ones most likely to have started their businesses from savings and many of them were victims of retrenchments or unemployment.

Table 10 - INFORMAL SMME FACTORS

INFORMAL SMME's FACTORS	FACILITATORS		BARRIERS		TOTALS
	FINANCIAL	NON FINANCIAL	FINANCIAL	NON FINANCIAL	
Lack of /access to formalization information				8	8
Increased Access to cash/credit	7				7
Access to a bigger market	4				4
Limited access to cash			4		4
Can't afford registration costs			3		3
Poor understanding of the benefits of formalization				3	3
Improved access to formalization information		3			3
Better business location		3			3
Business is too small				2	2
Document processing delays				2	2
Lack of business management skills				2	2
Better business skills		1			1
Fear of the law/need to be compliant		1			1
Better understanding of formalization benefits		1			1
Fear of paying taxes			1		1
Discouragement from SARS				1	1
Believes that there's no benefit being a tax payer			1		1
Doesn't trust that government will utilize taxes effectively		1			1
Ease of registration		1			1
Totals	11	11	9	18	49

The most frequently reported factor was a non financial barrier, namely the lack of or access to formalization information with 8 mentions. This group felt strongly that they could not easily access the government's formalization

information and infrastructure within their neighborhood and felt that going all the way to Pretoria was a bit too much to ask of them.

Other interesting notables in the top 5 rank ordered factors, was the poor understanding of the benefits of formalization and the lack of business skills. On the latter, most felt that they had the necessary skills to run a formal business but when probed further on things like book keeping, marketing, accounting, tax filing etc, they admitted they were lacking in skills. They assumed that their technical skills were all they needed and were not aware of the business skills needed as well. Marketing, for example, will need a change in mindset from them doing business with people they know in their neighborhood, as informal businesses, to trying to reach people whom you don't know or never see, as formal businesses.

The next section looks at the data from a facilitator or barrier perspective, financial or non financial.

5.9 Non financial barriers (NFB)

The detailed factors were taken together and combined into four separate categories; Financial and non financial barriers and financial and financial facilitators. This time, the aim was to look at the data from the angle of the formal and informal groups under the four categories.

The findings in this next step of analysis, were rank ordered, and are found in table 11 below.

Table 11 - NON – FINANCIAL BARRIERS

BARRIERS			
NON FINANCIAL	FORMAL	INFORMAL	TOTALS
Lack of or access to formalization information	4	8	12
Complexity of registration requirements & process	5		5
Lack of business management skills	3	2	5
Document processing delays	2	2	4
Poor understanding of the benefits of formalization	1	3	4
Business revenue is too small	1	2	3

A total of 33 mentions were raised under the non-financial barriers section in Table 11 above. Of the top 5 non-financial barriers as perceived by the respondents, three are related to infrastructure that is supposed to facilitate the ease of formalization e.g. the lack of access to information, complexity of registration and document processing delays. Together these three had a total of 21/33 (64%) mentions under this heading. The other two mentions in the top five under this heading were either related to lack of understanding on the benefits of formalization or lack of skills by the respondents.

The respondents overwhelmingly stated that the main non-financial barrier to formalization is the lack of or access to information on formalization, i.e. 60% of the respondents reported this (12/20). This was also one of the two factors that had the highest number of mentions by the respondents in this whole study. Complexity of registration requirements and process as mentioned by five respondents i.e. 25% (5/20) and was the second highest ranked factor.

In conclusion of this non-financial barriers (NFB) section, the majority of the mentions under this heading, 64%, are related to the inefficiencies of the

formalization process and or infrastructure, while the rest are related to either lack of business skills or ignorance on the benefits of formalization on the side of the respondents. Complexity of the registration process is only mentioned by those who have been through it and they could either encourage or discourage others.

5.10 Financial barriers (FB)

This section will now look at the perceived financial barriers as perceived by all interviewees, formal and informal. Table 12 below gives a detailed breakdown of the financial barriers.

Table 12 – FINANCIAL BARRIERS

BARRIERS			
FINANCIAL	FORMAL	INFORMAL	TOTALS
Limited access to cash	6	4	10
Can't afford registration costs	1	3	4
Costs of staying formal	2		2
Lack of access to bigger markets	1		1
Lack of equipment	1		1

Under the financial barriers section, there were a total of 5 factors and 18 mentions identified as seen in Table 12 above. Only the top two factors had mentions from both groups. The other three were only raised by the formal group. 50% of the interviewees, 10/20, overwhelmingly stated limited access to cash was their biggest financial barrier. The next two highest factors were all linked to either the costs of becoming or staying formal.

In concluding financial barriers, Limited access to cash (mainly start up capital) and the entry and maintenance costs of formalization are the highest ranked financial barriers, as reported by the interviewees.

5.11 Financial facilitators (FF)

A total of four factors and 24 mentions were identified as seen in table 13 below. Of these four factors, two were mentioned by both groups and the other two were mentioned by only the informal group.

Need to access a bigger market and increased access to cash, were unanimously the two main financial facilitators. Need to access a bigger market was mentioned more by those who had transitioned and a need for increased access to cash was mentioned more by the informal interviewees. Fear of paying taxes and the lack of value in paying taxes were raised a respondent each, in the informal group.

Table 13 – FINANCIAL FACILITATORS

FACILITATORS			
FINANCIAL	FORMAL	INFORMAL	TOTALS
Access to a bigger market	8	4	12
Increased Access to cash/credit	3	7	10
Fear of paying taxes		1	1
Believes that there's no benefit being a tax payer		1	1

In summary, the increased chances of a business growing by reaching more customers and or increased access to either working or start up capital are the main financial facilitators as perceived by the respondents.

5.12 Non financial facilitators (NFF)

In this category of non-financial facilitators (NFF), there was about an equal split of total mentions between the formal and informal groups, 13 vs. 12 as seen on table 14 below. Of the top 5 non financial facilitators, three were common to both groups, i.e. need for improved access to formalization information, need to be compliant and the ease of registration.

A better business location was only mentioned by the informal group whereas the support from business partners, friends and family was only mentioned by the formal group.

Table 14 – NON FINANCIAL FACILITATORS

NON FINANCIAL FACILITATORS			
NON FINANCIAL	FORMAL	INFORMAL	TOTALS
Improved access to formalization information	1	3	4
Fear of the law/need to be compliant	3	1	4
Better business location		3	3
Ease of registration	2	1	3
Support from MNC business partners, Family & friends	3		3
Presence of technical skills	2		2
Better business skills		1	1
Better understanding of formalization benefits		1	1
Discouragement from SARS		1	1
Doesn't trust that government will utilize taxes effectively		1	1
Need for professional image	1		1
Response to Government campaign	1		1

In summary, improved access to formalization information is perceived as the biggest non-financial facilitator for the informal group and the need to compliant with the laws and regulations is the biggest non-financial facilitator for the formalized group.

In the next chapter, 6, the above results will be discussed in relation to the research proposal and literature review.

CHAPTER 6 DISCUSSION OF RESULTS

6.1 INTRODUCTION

In this chapter, we shall review the results found from the survey against the propositions as stated in chapter 3 and conclude whether we should reject or accept the stated propositions

6.2 PROPOSITION 1:

Lack of access to affordable capital or credit is the major perceived financial barrier to transitioning from the second to the first economy in South Africa.

6.2.1 Research Findings

The research findings on the perceived financial barriers, as seen on table 12, clearly highlight that limited access to cash is the most important perceived financial barrier. The cash in this case, is needed for the formalization process e.g. registration costs and for covering the costs of staying formal e.g. compliance costs like licenses and ability to have the business capabilities that can effectively enable one to compete with the other formal sector businesses e.g. marketing, financial skills, legal needs for contracts and other related expenses.

In other instances, the informal businesses perceived themselves to be too small to formalize. Hence the cash from their perspective would be working capital to grow their businesses so as to make it worth it for them to formalize.

Some of the comments raised in the interviews are that there's a general phobia to approaching banks due to the perceived high costs of borrowing from banks, i.e. interest rates, and the stringent qualifying criteria needed by the banks e.g. credit records, registration certificates etc. There are even reports that title deeds from Alexandra are not accepted as security by banks due to the fact they are located in Alexandra. This means that property rights are inconsequential for people living in Alex.

Stokvels are perceived as being too expensive to borrow from. As a result, the majority would rather save and invest than borrow to invest. The research findings support the literature findings below.

6.2.2 Literature review findings

There are many constraints on entering the formal sector. The overarching issue is one of the costs versus the benefits for the individual entrepreneur who has to choose between formal and informal operations. In most countries, it's costly to be formal (Unleashing entrepreneurship, 2004).

Ishengoma and Kappel (2006) state that financial costs of formalization can be categorized as either entry costs which include all you licenses, registration some upfront bribery or operating costs which include compliance costs e.g. filling out government forms, taxes forms, business administration and labour regulations amongst others. In table 12 above, there were 6 explicit mentions in the interviews

on the entry and maintenance costs of formalization as financial barriers. Amongst the limited access to cash comments, some of the interviewees stated that the cash was also to stay formal e.g. outsource for an accountant, lawyer tax consultant etc.

Financial costs of entry into the formal sector, excluding required modifications in the business premises are estimated at an average of ten percent of annual profits in Latin American countries (Tokman, 1992). These costs rise with any increased need of modification to the business.

In South Africa, Schoombee (2003) states that the lack of access to formal bank credit is one of the important problems faced by South African micro-entrepreneurs in the informal sector. Although the government has addressed these issues, private banks are still not interested in serving micro-enterprises. This is heavily supported by the findings in this research study; the lack of access to cash was the highest mentioned factor within the financial barriers.

Ishengoma and Kappel (2006) state that in developing countries, majority of SMME's lack access to formal financial services. Between 1995 and 2004, only 9% of informal firms in Jamaica, Nigeria and Tunisia had access to bank loans. The number stands at 4% in Uganda. In Nigeria, funds offered by micro finance institutions (MFI'S) were more relevant to the subsistence SMME owner but not high enough for profitable investments. In Tanzania, it appears to be more expensive to borrow from MFI'S than from formal institutions.

6.2.3 Conclusion

In conclusion, the above stated proposition that “Lack of access to affordable capital or credit is the major perceived financial barrier to transitioning from the second to the first economy in South Africa” is accepted. This has not only been identified in the literature review but has also been confirmed by the research findings.

6.3 PROPOSITION 2:

Lack of skills on how to access a bigger market will be the main perceived non financial barriers to transitioning from the second to the first economy.

6.3.1 Research findings

The research findings on the perceived non-financial barriers as seen on table 11 overwhelmingly highlight that “The lack of or access to information on the formalization process” as the major perceived financial barrier amongst the interviewees.

Some of the comments that came through from the interviews are that the people don’t know how to go about the formalization formalities or where to go for help. As and when they do find out where to go, i.e. to Pretoria, then it’s too far for many of them. There seems to be help within Alexandra, via the business place, but it’s not widely known to all. Some of the interviewees also felt there was need

to not only have upfront information but also continued support on how to best run their businesses post the formalization process.

Other non financial barriers identified were the complexity of registration, lack of business management skills, delays in processing formalization documents and a poor understanding of the benefits of formalization.

6.3.2 Literature review

Farrell (2006) states that informal businesses, even large ones choose to stay that way if there's no change in the factors that generally drive them e.g. high corporate taxes and the bureaucratic burden of operating informally. Informality can also be encouraged by the high costs of formalization e.g. the 152 days it takes to register a business in Brazil vs. 6 in Singapore.

Ishengoma and Kappel (2006) highlight that limited human capital/skills, utilization of obsolete technology, poor location of businesses, limited access to markets and business support services and lack of incentives for operating in the formal sector as other barriers to formalization. This point is indeed by the 3 mentions of the lack of business skills as a non-financial barrier by the interviewees.

Job satisfaction within the informal sector is another consideration. On average, independent workers, either self employed or micro-enterprise owners in countries in Latin America and the Caribbean in which data was available, reported levels of welfare or job satisfaction similar to those they would have obtained if they held formal jobs for which they are qualified(World Bank, 2007). Indeed, one of the

informal SMME interviewees had been so successful in her business that she'd managed to school her kids through to university and even bought herself a house and a car. Hence for her, formalization was not a priority.

6.3.3 Conclusions

The above proposition that “Lack of skills on how to access a bigger market will be the main perceived non financial barriers to transitioning from the second to the first economy” is rejected. The research findings identify that “The lack of or access to information on the formalization process” is the main perceived non-financial barrier. This' in partial contrast to the literature findings identified in chapter 2. It's partial because Ishengoma and Kappel (2006) highlight that limited human capital/skills is one of the barriers of formalization which is also raised by the interviewees as the lack of business skills.

6.4 PROPOSITION 3:

Improved business capabilities to enable access to a bigger market will be the main perceived non financial facilitator for the transitioning of businesses from the second to the first economy.

6.4.1 Research Findings

The research findings on the perceived non financial facilitators, as seen on table 14, show that there are two equally ranked factors that have emerged. The

two non-financial facilitators identified are improved access to formalization information and the fear of the law/need to be compliant. The latter is overwhelmingly representative of the formal group factors and the former more of the informal group.

Some of the things that emerged from the interviews were that where it was easy to access the information e.g. via the business place in Alex, then the process was much easier. In the case of the responses related to the need to be compliant/fear of the law, a major driver of this decision was that it's easier to be compliant than have to deal with corrupt government officials.

Other non financial facilitators identified include a better business location, ease of registration and support from MNC partners, friends and family.

6.4.2 Literature review

Ishengoma and Kappel (2006) state that one would need access to skilled labour and capital and these could both be inputs into the formalization process or facilitators of the process. Having access to legal advice also helps the firms to be able to draw up and formalize contracts that would protect them. The research findings support the need for improved access to formalization information as one of the two main non-financial factors. The lack of legal advice is evidenced by the poor enforcement or total lack of contracts between MNC's and shop owners e.g. for advertising on their shop walls.

On Business location, Morrison (1995) emphasizes that all businesses should have equal chances to operate in good locations provided they abide by the

rules governing these localities. There were 3 mentions in the research on better business locations being a non-financial facilitator.

Promotion of informal-formal sector and multi-lateral linkages will help firms in the IS benefit from a reliable market, financial support, technology transfer and training and supervision (Ishengoma and Kappel, 2006). Measures which governments may take to promote linkages include: first, the reservation of a significant percentage of public orders for those SMME's that comply with regulations. This may encourage formalization. Secondly to address the exploitative nature of the formal-IS linkages and to enhance the institutional environment in which they operate. Part of this could include cutting out the middlemen and linking the producers directly to the buyers as Sri Lanka is aiming to do with its farmers (Becker, 2004). A third suggestion from the author of this study is for the government to give preferential treatment to those firms that are supporting SMME's similar to what is being done with BEE where the formal firms earn "points". Firms can even be encouraged to teach their skill to these SMME's or offer the employees of the SMME's learnership opportunities in order to improve workers' capabilities." This was also observed in the research as being present where some MNC's encouraged anyone whom they did business with to be registered and formal and they assisted them through the formalization process by e.g. via skills transfer.

6.4.3 Conclusions

In conclusion, the stated proposition that "Improved business capabilities to enable access to a bigger market will be the main perceived non financial facilitator

for the transitioning of businesses from the second to the first economy” is rejected. This is based on the research findings that identify two other equally ranked facilitators i.e. improved access to formalization information and the fear of the law/need to be compliant as the most important non financial facilitators.

The research findings do not fully contrast or concur with the literature review. For example, whereas there isn't any mention in the literature review about how improved access to formalization information facilitates the formalization process, there is consistency between the research findings and literature review when it comes to the need for a better business location, partnerships between the informal and formal businesses and need for improved business skills facilitate the formalization process.

6.5 PROPOSITION 4

Increased access to affordable cash or credit will be the main perceived financial facilitator.

6.5.1 Research findings

The research findings on the perceived financial facilitators, as seen on table 13, show that the possibility of increased access to a bigger market, with 12 mentions, is the main financial facilitator in the formalization process. This is however more heavily reported by those who have transitioned vs. those who haven't, 8 vs. 4 mentions. The possibilities of reaching more customers and hence

making more money, is a significant motivator for the interviewees for them to consider formalization. For the ones who had transitioned, they realized that they had to be a formal business in a larger formal market and hence the higher reporting from the formalized group.

The second ranked financial facilitator is the need for increased access to cash or credit, with 10 mentions. For many of the interviewees, the lack of cash was a major bottleneck. Many of them saved to invest. They hardly ever borrowed from the banks. There's a general apathy towards banks with the interviewees stating that they use the same qualification criteria for offering credit to a Sandton customer as they would for a customer operating in Alex. Many have tried the banks for loans but have been discouraged by the banks' stringent requirements. They also have a phobia of not being able to keep up the interest payments.

6.5.2 Literature review

Avoiding costs of being informal is a good incentive to formalize. Ishengoma and Kappel (2006) state that operating within the IS has its own costs e.g. Penalties and corruption. In Peru, 10% to 15% of an enterprises gross income goes towards bribes while formal firms pay about 1% (De Soto, 1992). In transition economies, informal firms can incur bribes of up to 20% of their revenue (Djankov *et al*, 2002). When government officials benefit from the formalization process of informal enterprises (for example by receiving bribes), they may in fact retard the formalization process (Loazya, 1997).

The costs of capital in the informal sector can be quite high. De Soto (1989) points out that in Lima in 1985, the nominal borrowing rate for informal firms was 22% monthly, whereas it was 4.9% for formal firms of comparable size. The high costs of capital could limit any expansion efforts.

The real challenge for the government is to help the second economy obtain finance and market related information on how and where to market their services. She states that the inability to borrow against property or future earnings prevent the poor from investing in entrepreneurial ventures and assets for wealth creation such as education (Kirsten *et al*, 2006).

6.5.3 Conclusion

In conclusion, the above stated proposition that “Increased access to affordable cash or credit” will be the main perceived financial facilitator in the transitioning of businesses from the second to the first economy is rejected. This conclusion is based on the fact the research identified the possibility of being able to gain access to a bigger market as the main financial facilitator/motivator and this is further supported by the literature.

The research also does show that that the ability to be able to access cash or credit as the second ranked financial facilitator for the whole group but the first ranked for the informal SMME subset.

6.6 PROPOSITION 5:

SMME owners in the second economy do not have an appreciation of the benefits and facilitators of formalization.

6.6.1 Research findings

The research findings as seen on table 10 show that there were three mentions of the fact there was little appreciation of the full benefits of formalization. These mentions were recorded as such when they were explicitly mentioned during the interviews. However, in the course of the interviews, there were extensive comments made by the interviewees that hinted at their lack of full appreciation of the benefits of formalization. For example, some of them would not understand why the banks would not lend their businesses money even without any certificates of registration or why as informal businesses, they could not access government grants e.g. Umsobomvu youth fund.

Another example was the glaring lack of any contracts offered by MNC's to shop owners when they branded their stores with products from MNC's. MNC's are taking serious advantage of the ignorance of the people in Alex to get free advertising in the disguise of giving the stores a free coat of advertising paint every so often. These shop owners got no money for the advertising on their stores because they didn't know their rights and could not enforce contracts as informal businesses. In the cases where people offered to pay tax, some of the reasons

given were that it was cheaper to do so than to bribe the authorities if caught and not for the potential government penalties they could face..

6.6.2 Literature review

Loazy (1997) states that there's also need for access to public services e.g. legal services. Informal enterprises are poorly protected by the national security system and are thus subject to many crimes and high transaction costs related to high opportunism from business partners; a situation that may force them to trade with people they know, hence limited market growth and potential. One can therefore conclude that for them to grow, they must tap into the public services that would enable them to get legal recognition and protect.

6.6.3 Conclusions

In conclusion, on the above stated proposition that "SMME owners in the second economy do not have an appreciation of the benefits and facilitators of formalization" will be accepted. There's a varied level of understanding of the full benefits of formalization amongst the informal SMME owners. This view is supported by literature review above.

6.7 Chapter 6 conclusion

Based on the research findings, of the 5 propositions stated in this study, 2 were accepted, while 3 were rejected as seen below:-

- Proposition 1: Lack of access to affordable capital or credit is the major perceived financial barrier to transitioning from the second to the first economy in South Africa. - ACCEPTED
- Proposition 2: Lack of skills on how to access a bigger market will be the main perceived non financial barrier to transitioning from the second to the first economy. - REJECTED
- Proposition 3: Improved business capabilities to enable access to a bigger market will be the main perceived non financial facilitator for the transitioning of businesses from the second to the first economy. - REJECTED
- Proposition 4: Increased access to increased affordable cash or credit will be the main perceived financial facilitators. - REJECTED
- Proposition 5: SMME owners in the second economy do not have an appreciation of the benefits and facilitators of formalization. – ACCEPTED

In summary, three of the five propositions have been rejected.. This tells us that there's potentially a difference in the facilitators and barriers to formalization in the South African context as compared to what the literature shows to be in other countries.

Chapter 7, which is the final chapter of this research will now discuss the conclusions and recommendations as drawn from the research findings.

CHAPTER 7 – RESEARCH CONCLUSIONS

7.1 INTRODUCTION

This section of the report, being the final chapter, gives an overview of the main findings, presents further areas of research based on these findings and the literature, gives recommendations to various stakeholders, identifies future areas of research and finally gives an integrated summary of the entire research project.

The research carried out was exploratory and attempted to identify the perceived barriers and facilitators to transitioning of small businesses from the second (informal) to the first (formal) economy. The data was collected through face to face interviews using an interview guideline (See appendix 1) and analyzed using content analysis and frequency distribution method. The sample consisted of 20 SMME owners, 10 of whom had transitioned and 10 whom had not. They were all from Gauteng and all but one from the township of Alexandra in Johannesburg.

The motivation for the research came from the fact that, whereas there might have been some data from other developing countries, there was a gap in the South African context in understanding what the real facilitators or motivators and barriers are that are holding back the formalization of the informal sector. The conversion of enterprises from informal to formal concerns is not well researched and understood. In the absence of hard data, experienced observers and practitioners in the small business field express extreme skepticism about the efficacy of attempts to convert informal businesses to formal ones, (Bernstein, 2004).

7.2 SUMMARY OF RESULTS

This section of the chapter will consolidate the key findings against the research objectives and also mention some of the other notable findings.

7.2.1 Non financial barriers

The lack of, or access to, information on formalization is overwhelmingly the biggest perceived non financial barrier. Of the 12 mentions against this finding, the formal: informal groups split was 4 and 8 respectively (Table 11).

Other notable mentions under this sub heading were, in rank order:-

- i. Complexity of the registration process and requirements
- ii. Lack of business management skills.
- iii. Delays in processing documents e.g. issuing of registration certificates
- iv. Poor understanding of the benefits of formalization
- v. Business revenues being too small for them to formalize.

7.2.2 Financial Barriers

Limited access to cash was the biggest perceived financial barrier with 10 mentions. The formal: Informal groups split was 6 and 4 respectively (Table 12).

Other notable mentions identified were, in rank order:-

- i. Inability to afford the costs of registration
- ii. High costs of staying formal.

7.2.3 Financial facilitators

Access to a bigger market, with 12 mentions, was the biggest perceived financial facilitator/motivator. The formal: Informal groups split was 8 and 4 respectively (Table 13).

Other notable mentions were, in rank order:-

- i. Increased access to cash/credit (10 mentions with a 3 and 7, formal: Informal group split respectively)

7.2.4 Non financial facilitators.

There were two main, equally ranked, perceived non financial facilitators that emerged. The first one was improved access to information on formalization with 4 mentions and a formal: Informal groups split of 1 and 3 respectively. The second was the “fear of the law/need to be compliant” with 4 mentions and a formal: informal groups split of 3 and 1 respectively.

Other notable mentions were, in rank order:-

- i. A better business location
- ii. Ease of registration
- iii. Support from business partners, friends and relatives

Table 15 below will present a summary of the key findings under either financial or non-financial barriers or facilitators. Note that under financial facilitators, there are two factors because of the close frequency of mentions.(12 & 10). Notice the contrast between facilitators and barriers.

Table 15 - SUMMARY OF KEY FINDINGS; BARRIERS AND FACILITATORS

SUMMARY OF KEY BARRIERS AND FACILITATORS		
	BARRIERS	FACILITATORS
NON FINANCIAL	Lack of access to information on formalization	Improved access to information on formalization
FINANCIAL	Limited access to cash or credit	Ability to or access to a bigger market. Increased access to cash credit

7.3 RECOMMENDATIONS

This section of the chapter will put forward recommendations, to four stakeholder groups, on how to facilitate formalization by creating facilitators & eliminating perceived barriers. The four stakeholders are government, Informal SMME owners, formal sector SMME owners and Multinational corporations

7.3.1 Government

- i. Increase the awareness on the benefits of formalization in the informal sector so that you can get commitment and not compliance to the formalization process.
- ii. Make it easy for people to access formalization information and machinery so as to facilitate the formalization process. For example either set up or facilitate the setting up of offices within the informal sector areas so as to enable easier access by the people.

- iii. Set up tracking processes to check for the impact of the formalization efforts, then evaluate, learn and adjust accordingly.
- iv. Facilitate the provision of core formalization services to the informal sector e.g. legal, tax etc either directly or through third parties. This should especially focus on businesses in their first three years of a formalized operation
- v. Work with the communities to find out how to best communicate and reach the people.
- vi. Scrap registration fees to reduce entry barriers.
- vii. Reduce minimum wages to enable increased employment in the formal sector.
- viii. Minimize and simplify the formalization requirements, depending on the size or nature of the business, so as to minimize both the entry and maintenance costs of formalization. How can you, for example, simplify tax filing for an illiterate, SMME owner?
- ix. Ensure that your economic policies are also pro-poor and address the income disparity in South Africa through better income distribution.
- x. Insist on compliance from the MNC's that they only do business with formal entities and put penalties for non compliance. The same goes to their partners e.g. wholesalers in these areas
- xi. Increase enforcement initiatives.

- xii. Increase the points available to corporations for enterprise development, procurement and skills transfer pillars under the BBBEE codes.
- xiii. Incorporate basic business skills in final year school curriculum. Then facilitate access to increased business skills thereafter e.g. encourage and partner the likes of the business place to set up offices in the townships.
- xiv. Facilitate the ease of access to government grants.

7.3.2 Informal SMME owners

- i. Seek to understand the benefits of registration.
- ii. Register your businesses. It will improve your ability to access the formal machinery e.g. uphold contracts, business advice & skills, credit from banks, access into a wealthier market etc

7.3.3 Formal SMME owners

- i. Leverage shared services for capabilities needed to stay formal e.g. how can a number of businesses get together to share HR, payroll, legal and accounting services.
- ii. Access existing machinery to improve your business capabilities e.g. the Business place.
- iii. Leverage your relationships with MNC's to seek transfer of skills.

- iv. Mentorship programs should be set up to showcase role models.

7.3.4 Multi National companies & NGO's

- i. Financial institutions should come up credit/cash access products for the informal sector.
- ii. Create flexible business models that incorporate those emerging from the informal sector.
- iii. Be responsible in your business practices so as to facilitate the transformation initiatives in South Africa.
- iv. Develop your business partners and their communities. Mentor them

7.4 FUTURE RESEARCH AREAS

Based on the findings of this research, and by its exploratory nature, below are a couple of potential spin-off research areas that can be further investigated in the near future:-

- i. Quantify the weighting of the above identified barriers and facilitators in order to understand the most and least important in the formalization decision and why?
- ii. What are the optimum communication programs needed to effectively deliver and track impact of formalization initiatives in the informal sector?
- iii. How effective are the government initiatives at reducing informality?

- iv. Considering the inherent limitations e.g. illiteracy, inability to speak English etc within the informal sector, how does the government simplify the formalization process?
- v. How can the formalization process be customized to fit in with the different kinds and sizes of businesses and capabilities of the business owners?
- vi. How does the attitude of businesses owners in the informal sector towards financial leveraging affect their ability to grow their businesses?
- vii. What are the specific roles of Government, civic society, multinational organizations and NGO's in reducing informality?
- viii. Is the informal sector an asset or liability to South Africa's economy?
- ix. What are the pros and cons of the sustainability of the informal sector to the South African economy?
- x. How does the economy minimize the initial costs of entry and maintenance for businesses that are in their first three years of formalization?
- xi. What is the impact of BBBEE codes on informality?
- xii. What is the correlation between levels of crime, size of businesses and informality in the townships?

7.5 INTEGRATIVE SUMMARY

The presence of the informal sector in South Africa creates significant challenges in the government's efforts to, plan and allocate resources, track economic parameters and progress, alleviate poverty and elevate standards of living.

To aid in the formalization process, SMME owners must have easy access the formalization machinery and information. Bringing these services closer to the people will be a good start. They must also be educated on the benefits of formalization. There must also be solutions sought to address the difficulty faced by the informal SMME owners to access financial resources. The government and Multinational companies also have a role to play in facilitating formalization through enforcement and compliance to the law and enabling increased access of small businesses to bigger markets and better business skills.

Another challenge identified that needs to be addresses is that of keeping the formal SMME's formal and not letting them slip back into informality. It will therefore be important for the SMME owners to have clarity on expectations and benefits of formalization prior to going through the formalization process. Efforts should also be made to make it as easy for them as possible to stay formal by reducing or simplifying the costs and requirements of staying formal, e.g. through cost effective compliance legal, accounting, tax filing services and simpler interpretations of tax and labour laws etc.

The conversion of enterprises from informal to formal concerns is not well researched and understood. In the absence of hard data, experienced observers

and practitioners in the small business field express extreme skepticism about the efficacy of attempts to convert informal businesses to formal ones, (Bernstein, 2004). Hopefully, this study has helped shed some light onto the barriers and facilitators involved in the transitioning process of informal enterprises to formal enterprises and in the process, further clarified how enterprise formalization can be made simpler and quicker in South Africa so as to unleash the economic potential of the informal economy.

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CHAPTER.9 APPENDICES

APPENDIX 1

INTERVIEWING GUIDELINE

1. Have you transitioned from an informal to a formal business? Yes or no
2. If yes, why, if no why not? If you answered No to Q1, go to Q3. If you answered yes, go to Q5
3. **What has prevented you from transitioning?** Financial/ Non Financial
 - a. .
 - b. .
 - c. .
4. **What could motivate you to transition**
 - a. .
 - b. .
 - c. .
5. **What facilitated your transition?** Financial/Non financial
 - a. .
 - b. .
6. **What hindered or slowed down your transition?**
 - a.
 - b. .
 - c.