



Determinants of the Level of Informality of Informal Micro-Enterprises: Some Evidence from the City of Lahore, Pakistan

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Summary. — Recognizing that enterprises operate at varying levels of informality, this paper evaluates the determinants of their degree of informality. Reporting a 2012 survey of 300 informal microenterprises in the city of Lahore in Pakistan, the finding is that the key predictors of their level of informality are the characteristics of the entrepreneur and enterprise, rather than their motives or the wider formal and informal institutional compliance environment. Lower degrees of informality are associated with women, older, educated, and higher income entrepreneurs and older enterprises with employees in the manufacturing sector. The paper concludes by discussing the theoretical and policy implications.

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1. INTRODUCTION

Based on the recognition that entrepreneurs and enterprises operating in the informal sector are a persistent and extensive phenomena across the global economic landscape, a burgeoning literature has discussed whether such entrepreneurs and enterprises are driven out of necessity into the informal sector due to their exclusion from the formal sector, whether they voluntarily exit the formal sector, or some combination of the two (Maloney, 2004; Perry *et al.*, 2007; Williams, Nadin, & Rodgers, 2012). The emergent finding has been that there is what Fields (1990, 2005) terms an exclusion-driven “lower tier” and exit-driven “upper tier” of informal sector entrepreneurship and enterprise. However, this literature has so far only sought explanations for entrepreneurs and enterprises operating in the informal rather than the formal sector. Despite the growing recognition that informal entrepreneurs and enterprises often display varying levels of informality in that they conform to the formal rules and regulations in some regards but not others (Andrade, Bruhn, & McKenzie, 2013; Bruhn & McKenzie, 2013; de Villiers, Verreyne, & Meyer, 2014; Kanbur, 2009; Ram, Edwards, & Jones, 2002; Ram, Jones, Abbas, & Sanghera, 2002; Small Business Council, 2004; Verreyne, Meyer, & Liesch, 2014; Williams, 2006; Williams & Martinez, 2014), no studies have so far sought to explain the reasons they operate at varying levels of informality. To start to fill this gap, the aim of this paper is to start to evaluate the determinants of the level of informality of informal microenterprises. The reason this is important is because most supra-national agencies and governments are seeking to facilitate the formalization of informal sector enterprises and entrepreneurs (European Commission, 2007; ILO, 2014; OECD, 2012). However, unless the determinants of the level of informality of informal enterprises and entrepreneurs are known, targeted and tailored policy initiatives cannot be developed to enable informal enterprises and entrepreneurs to progress along the spectrum from informality to formality.

In the first section therefore, the literature is reviewed on informal sector entrepreneurship and enterprise in terms of what is known about its magnitude, characteristics, and determinants. Identifying that despite the rapid growth in this

literature, studies have largely failed to analyze the varying levels of informality of informal enterprises and what determines their level of informality, the second section then introduces the data and methodology here used to do so. Reporting a 2012 survey of 300 micro-enterprises employing less than ten employees operating in three sectors where informality is prominent, namely the retail, manufacturing, and instantly consumable food (ICF) sectors, in the city of Lahore in Pakistan, a multivariate-ordered logistic regression analysis and post-estimation exercises are used to identify the key determinants of their level of informality. The third section reports the results. Revealing that unlike previous studies which find that the decision to be informal or formal can be explained in terms of entrepreneurs’ motives and the wider formal and institutional compliance environment, the key determinants of their level of informality are the characteristics of the entrepreneur and enterprise, the final section then discusses the theoretical and policy implications.

Before commencing however, what is here meant by informal sector micro-enterprise needs to be defined. Drawing upon the widely-used recommendations of the 15th and 17th International Conferences of Labor Statisticians (ICLS) and in particular their enterprise-based definition of the informal sector, informal sector enterprises are defined as small or unregistered private unincorporated enterprises (Husmanns, 2005). Breaking this down, small refers to when the numbers employed are below a specific threshold, determined according to national circumstances. Here, this is taken as less than 10 employees, which is the standard definition of a micro-enterprise in Pakistan (Federal Board of Revenue of Pakistan, 2008). An unregistered enterprise in this ICLS definition is one not registered under specific forms of national-level legislation (e.g., factories’ or commercial acts, tax or social security laws, professional groups’ regulatory acts). In this paper in the context of Pakistan, we define as unregistered an enterprise

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not registered with the tax authorities for tax purposes. A private unincorporated enterprise meanwhile, is defined by the ICLS as an enterprise owned by an individual or household that is not constituted as a separate legal entity independent of its owner, and for which no complete accounts is available that would permit a financial separation of the production activities of the enterprise from the other activities of its owner (Husmanns, 2005; ILO, 2011, 2012). For the purposes of this paper therefore, and following this ICLS definition, an informal micro-enterprise in Pakistan is defined as a private enterprise employing under 10 employees which is either: not constituted as a separate legal entity independent of its owner; is not registered with the tax authorities for tax purposes, and/or no complete formal accounts are kept enabling a financial separation of the enterprise from the other activities of its owner/s. This, as will be returned to below, provides a basis for informal sector micro-enterprises to be analyzed according to their varying levels of informality.

2. INFORMAL ENTERPRISE AND ENTREPRENEURSHIP: PREVALENCE, CHARACTERISTICS, AND DETERMINANTS

In recent years, there has been a burgeoning literature on enterprises and entrepreneurs operating in the informal sector (Dau & Cuervo-Cazurra, 2014; Kistruck, Webb, Sutter, & Bailey, 2014; Radchenko, 2014; Siqueira, Webb, & Bruton, 2014; Thai & Turkina, 2014; Webb, Bruton, Tihanyi, & Ireland, 2013; Webb, Ireland, & Ketchen, 2014; Webb, Tihanyi, Ireland, & Sirmon, 2009; Williams & Martinez, 2014). Despite this, the amount of research devoted to this subject remains relatively minor when one considers the widespread prevalence of informal sector enterprise and entrepreneurship. Estimates suggest that the informal sector is equivalent to 40–60% of GDP in emerging economies and around 10–15% in developed economies (Schneider & Williams, 2013), and that 1 in 6 (16.6%) of the global non-agricultural workforce are own-account workers or owners of informal sector enterprises and one-third (31.5%) have their main job in informal sector enterprises (Williams, 2015). Moreover, nearly two-thirds of global enterprises have been argued to start-up unregistered and operating in the informal sector (Autio & Fu, 2014). Indeed, in Pakistan, the focus of this paper, the informal sector is estimated to equal 33.5% of GDP (Schneider & Williams, 2013), 32.9% of the non-agricultural workforce are own account workers or owners of informal enterprises, and nearly three-quarters (73%) have their main job in informal sector enterprises (Williams, 2015). Both in the global economy in general and Pakistan in particular, the informal sector is therefore far from some marginal enclave. It is a sizeable segment of the economy.

Although less is known about the nature of informal sector enterprises than formal enterprises, there have been in the last few decades considerable advances in our understanding of the nature of entrepreneurs and enterprises operating in the informal sector not only in Pakistan in particular (Burqi & Afaqi, 1996; Gennari, 2004; Kemal & Mahmood, 1998) but also more widely (Aidis, Welter, Smallbone, & Isakova, 2006; Bureau & Fendt, 2011; Siba, 2015; Thai & Turkina, 2013; Webb *et al.*, 2013). A U-shaped pattern has been identified in relation to the age of owners of informal enterprises, with younger and older people more likely to operate informally, both in Pakistan (Federal Board of Revenue of Pakistan, 2008; Gennari, 2004) and elsewhere (e.g., Asian Development Bank, 2010; Williams & Martinez, 2014), often explained in

terms of the lack of formal jobs and alternative means of social support for younger and older age groups respectively. Informal enterprise is also found to be concentrated among lower-income populations (Ahmad, 2008), although this has been argued to differ across populations, not least depending upon the level of social protection available (Williams, 2014). In economies such as Pakistan with large informal sectors moreover, those with higher levels of formal education and training are not found to be more likely to operate formally as might be supposed but rather, to move from being *shagirds* (unskilled apprentices) to *ustads* (master craftspeople) and self-employed, and receive higher wages (Arby, 2010; Burki & Khan, 1990; Burqi & Afaqi, 1996; Khan, 1983). Indeed, Kemal and Mahmood (1998) find that informal entrepreneurs are better educated than formal workers in a study of 11 Pakistan cities, as do Gurtoo and Williams (2009) in India. Both in Pakistan and elsewhere, women are more likely than men to both start-up their enterprises informally and to continue operating informally (Agarwala, 2009; Kemal & Mahmood, 1998; Mumtaz & Saleem, 2010; Williams & Gurtoo, 2012).

Examining the business characteristics of informal enterprises meanwhile, a recurrent finding is that the older the enterprise, the greater is the likelihood that it is formal (Thai & Turkina, 2014; Williams & Martinez, 2014), although in Pakistan a high proportion of established businesses operate informally (Kemal & Mahmood, 1998). Sectorial variations also exist with informality more prevalent in the distribution and construction sectors, with lower levels of informality in other sectors such as manufacturing (Asian Development Bank, 2010; Gurtoo & Williams, 2009; ILO, 2012). In Pakistan, similar tendencies are identified (Chaudhry & Munir, 2010; Kemal & Mahmood, 1998).

Besides these advances in understanding the prevalence and characteristics of informal enterprise, there has also been progress regarding the reasons for operating informally rather than formally. On the one hand, an exclusion perspective has viewed the growth of informal enterprise across the globe to be connected with the advent of a deregulated open world economy (Castells & Portes, 1989; Davis, 2006; Meagher, 2010; Slavnic, 2010; Taiwo, 2013). Diminishing state involvement in social protection coupled with increased outsourcing and subcontracting to reduce production costs is seen to be driving people into entrepreneurial endeavor as a survival strategy and last resort (Chen, 2012; ILO, 2014; Kantor, 2009; Meagher, 2010; Parizeau, 2015; Taiwo, 2013).

On the other hand, others have viewed informality more as a voluntary decision to “exit” the formal economy, rather than a result of involuntary exclusion (Cross, 2000; Snyder, 2004). This is argued by a diverse array of commentators, ranging from neo-liberals (De Soto, 1989, 2001), through institutional theorists (Webb *et al.*, 2009, 2013) to a range of critical, post-colonial, post-structuralist, post-development, and post-capitalist scholars seeking to unpack the messy logics of monetized transactions (Escobar, 1995; Snyder, 2005; Zelizer, 2005). The drivers underpinning this decision to voluntarily enter informal entrepreneurship have been variously asserted to be firstly, high tax rates (Ahmed & Ahmed, 1995; Arby, 2010; Hussain & Ahmed, 2006; Kemal, 2003, 2007), secondly, public sector corruption (Ahmed, 2009; Buehn & Schneider, 2012; Friedman, Johnson, Kaufmann, & Zoido, 2000; Gulzar, Junaid, *et al.*, 2010), thirdly, stifling bureaucracy and over-regulation (De Soto, 1989; Iqbal, 1998; Kemal, 2007; Shabsigh, 1995) and fourthly, resistance and resentment toward government due to a perceived lack of procedural and redistributive justice and fairness (Ahmed, 2009; FBR, 2008; Kemal, 2003; Torgler, 2003, 2011).

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