



Gender, Entrepreneurship, and the Formal–Informal Dilemma: Evidence from Indonesia

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Summary. — This study analyzes the preferences of entrepreneurs about formality and focuses on the role of gender. Relying on original data collected in Indonesia, we unpack the differences between various types of female entrepreneurs (currently in the informal sector) according to their preferences about formalization. Contrary to the existing literature, we find that female entrepreneurs possess highly nuanced preferences about formalization that are conditional on many factors. The preference for formalization is strongest among female entrepreneurs who are older, married, rural-based, and have recently started their firms. Our work contributes to research that seeks to better understand entrepreneurial preferences and the role that gender plays.

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1. INTRODUCTION

The informal sector plays an important role in developing countries as a source of income and employment. For entrepreneurs, the decision to open an informal firm—instead of a formal one—can be the result of numerous factors. Many entrepreneurs select the informal sector simply as the result of structural disadvantages according to their gender, income level, education, class, ethnicity, or religion. Around the world, gender discrimination leads women to look to the informal sector for viable income-earning opportunities. Cultural or state-sanctioned discrimination forces ethnic minorities to rely on the informal sector for survival. Many individuals prefer the informal sector when the government imposes high regulatory barriers to opening a formal firm or accessing credit. Despite certain advantages of informality, it can have a negative effect on an entrepreneur’s income-earning potential and hurt a firm’s ability to stay competitive over time.

Many studies posit that the informal sector is well-tailored to the needs of female entrepreneurs because it provides greater flexibility in terms of working hours, pace of work, and proximity of the job to one’s home (Bahramitash & Salehi Esfahani, 2011; Chen, 2001; Manning, 1998; Poncela & Steiger, 1996). Indeed, studies of developing countries highlight the overwhelming presence of women in the informal sector, particularly in trade-based activities and as own-account workers in household enterprises (for an overview of the literature, see Chant & Pedwell, 2008). Most women-owned firms are small-scale, self-financed, low-technology, and labor-intensive operations (Klapper & Parker, 2011). It is often argued that female entrepreneurs prefer the informal sector due to their family responsibilities, lower level of education, or the type and size of enterprise selected (World Bank, 2009, p. xiv).

This paper analyzes the preferences of entrepreneurs about the decision to formalize their informal firm, and specifically focuses on the role of gender. Relying on an original dataset collected in Indonesia, we take inspiration from the writings on gender and intersectionality (Crenshaw, 1991; Shields, 2008) and unpack the differences between various types of female entrepreneurs with regard to their preferences about

formalization. We find that the preference for formalization is strongest among female entrepreneurs who are older, married, rural-based, and have recently started their firms. Education is positively linked with a preference to formalize, but education does not interact with gender in any meaningful way. Entrepreneurs who prefer to formalize tend to reason that this will offer them greater security of operation. This is particularly the case for educated urban entrepreneurs and those who are members of an ethnic minority group. Female entrepreneurs are much more likely than male entrepreneurs to reason that formalization will help them access credit.

Our work contributes to a large body of research that seeks to better understand entrepreneurial preferences in developing economies, specifically as it pertains to gender differences and preferences about the formal *versus* the informal sector. Although much of the research on entrepreneurial preferences holds that female entrepreneurs have a preference for informality, our study finds instead that female entrepreneurs generally prefer the formal sector. However, their preferences are conditional on a number of other factors such as age, location of firm, and type of firm. Unpacking the preferences of female entrepreneurs is an essential part of understanding who in an economy benefits from formality, as well as which types of entrepreneurs are more likely to support (or reject) a push for greater formalization of the private sector.

We begin with a brief review of the existing research on informality, entrepreneurship, and the role of gender. Next, we discuss the case of Indonesia and introduce evidence from semi-structured interviews conducted in East Java during the summer of 2012. The following section outlines the methodology and descriptive statistics emerging from surveys that were subsequently conducted in North Sumatra and East Java in the fall of 2012. We employ logistic regression to uncover the determinants of an entrepreneur’s preference about formalization, as well as the reasons for their preference. The paper concludes by discussing the broader implications of our findings for scholars and development practitioners.

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2. INFORMALITY, ENTREPRENEURSHIP, AND THE ROLE OF GENDER

While there is no universal definition of the term “informal sector,” it is generally understood as a “heterogeneous group of activities and employment relationships that share one common characteristic—the lack of legal recognition, regulation or protection” (Lloyd-Evans, 2008, p. 1885).¹ Around the world, the informal sector plays an important role as a site of entrepreneurship and employment. According to the International Labour Organization (2002), 50–75% of all non-agricultural employment in the developing world exists in the informal sector. The World Bank estimates that the informal sector averaged 38.4% of GDP in Sub-Saharan African countries during 1999–2007 (Schneider, Buehn, & Montenegro, 2010). Even among high-income OECD countries, the informal sector was responsible for 13.5% of GDP on average. Although some characterize the informal sector as a barrier to development, it plays an important role in poverty alleviation and as a logical alternative to the formal sector when entry barriers are high.

A number of factors encourage informality. When there are high fixed costs to formal market entry (e.g., numerous regulatory procedures, high costs of registration, or high barriers to access credit), entrepreneurs generally prefer to open an informal firm (De Soto, 2002; Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2002; Klapper, Amit, Guillén, & Quesada, 2007; Straub, 2005). If the prevailing wage in formal employment is low, an informal firm may generate more income for an individual. Some prefer the informal sector because it offers greater independence and flexibility, not to mention the principal advantage of evading regulation and taxation. In countries that experience frequent economic shocks, the informal sector is better insulated from crisis and can function as a “safety net” for households (Looney, 2006; Wallace & Latcheva, 2006). Although there is a limit to the informal sector’s ability to absorb labor during a severe crisis (Galli & Kucera, 2003), in many countries it operates counter-cyclically as a source of employment during downturns (Loayza & Rigolini, 2011). Low levels of education or unequal access to information about credit can also encourage informality (La Porta & Shleifer, 2008; Maloney, 2004; Webster, 2005).

Notwithstanding the above, a range of negative consequences can result from situating one’s firm in the informal sector. Informal firms cannot benefit from property rights protection or contract enforcement laws provided by the state (Straub, 2005). Informal firms may be unable to access key public goods that enhance productivity, such as electrical power. Quantitative cross-national studies find that informal firms are substantially less productive than formal firms, even small-sized ones. This is likely explained by differences in human and physical capital. Formal firms tend to have better educated owners and better access to markets, services, and credit than informal firms (La Porta & Shleifer, 2008). In Ethiopia, very small informal firms have advantages over formal firms, but formal firms receive higher marginal returns to capital and overall profitability after controlling for capital stock (Siba, 2015). Furthermore, there may be a “lock-in” tendency among informal firms as their owners become more resistant to formalization over time.

While much of the quantitative work on the informal sector reveals its negative aspects, recent work in urban studies counters the commonly held association of informality with poverty and questions the utility of understanding economies as having an inherently dual nature (AlSaiyad & Roy, 2004;

Roy, 2009b). These scholars argue that informality is an ambiguous concept, one that is constantly in flux given the role of the state in defining what is informal and what is not (Roy, 2009a). Consequently, it is important to examine how government policymaking affects the nature of informality, and how different types of informality result. In many countries, such as India, the government pursues a strategy of economic development by taking certain economic activities and defining them as informal, and therefore “illegal” or “illegitimate” (Roy, 2009b). In this sense, the informal sector emerges not as an organic alternative to the formal sector but is instead a direct outcome of the government’s strategies for planning and development.

Does gender shape an entrepreneur’s preference about formality? Are female entrepreneurs more likely to prefer the formal sector or the informal sector? Much of the extant research finds that women prefer the informal sector because it provides greater flexibility in terms of working hours, pace of work, proximity of the job to one’s home, and ease of entry and exit (Bahramitash & Salehi Esfahani, 2011; Chen, 2001; Manning, 1998; Poncela & Steiger, 1996). For instance, a study of Nicaragua maintains that “Women prefer the informal sector, and it prefers them” (Poncela & Steiger, 1996, p. 53). Researchers also emphasize that a preference for informality may result from the types of sectors to which women gravitate, as well as the smaller-than-average size of most female-owned firms (World Bank, 2009). In the developing world, women are usually found in labor-intensive service and trade sectors, which are less regulated than capital-intensive sectors such as manufacturing. Smaller firms with few or no employees and those based at home are harder to regulate than large, publicly visible ones. A study of the Dominican Republic found that female-owned firms were significantly smaller than male-owned firms (about half as many employees), more likely to operate out of the home, and more likely to be own-account enterprises (Grasmuck & Espinal, 2000).

Female entrepreneurs face barriers to the formal sector that can force them into the informal sector. Research shows that female entrepreneurs have less access to credit from banks and financial institutions than their male counterparts (Klapper & Parker, 2011). Other studies find that the difference between men and women in rates of formal entrepreneurship is less the result of legal and institutional barriers but more due to unequal access to finance (Estrin & Mickiewicz, 2009). Domestic responsibilities can impede entrepreneurial success for women, restricting the growth of their firms and forcing them to remain in the informal sector. Unequal access to education has a negative effect on women who eventually become entrepreneurs. Educational attainment is positively linked with income for entrepreneurs, with a slightly higher impact on women (Van der Sluis, Van Praag, & Vijverberg, 2005).

The arguments and findings from the literature generate a number of theoretical predictions for our study. All else equal, female entrepreneurs who own informal firms should prefer to stay in the informal sector and not pursue formalization. This is especially the case for female-owned firms that engage in household enterprises and those that are open for a long period of time. Female entrepreneurs who are married should prefer to keep their firms informal, as this allows them greater flexibility to balance work with family responsibilities. Higher levels of education should be positively linked with a preference for the formal sector. Yet, the literature offers little insight into the role of age or the possibility of an urban–rural divide in preferences about formalization. Next, we discuss the

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