“An assessment of informal SMEs’ potential in an African economy – theoretical and conceptual framework”

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Informal Small and Medium Enterprises (SMEs) play a key role in their respective economies over the world particularly in the African continent. This paper reviews various theories on SMEs towards understanding the potential of the informal sector in the context of African countries. The paper uses a theoretical approach for the purpose of assessing the challenges that have affected the development of the informal SMEs sector over the years in both the developing and developed world. Economically developing countries in Africa pose unique challenges to informal SMEs development compared to the developed countries. The paper reviews the theories that define the rise to informality in Africa by identifying the key determinants for the emergence of informal SMEs. A conceptual framework for assessing informal SME’s potential for Africa is developed. The conceptual framework is based on the Fishbone diagram developed by Kaoru Ishikawa (1986). This paper discusses the intricacies of the applicability of the proposed conceptual framework to assess the potential of the informal SMEs in Africa and the way forward for the formalization debate.

**Keywords**

enterprises, SMEs, informal sector, informal economy, informalization

**JEL Classification**

E26, J46, O17, R12
sector and the challenges faced by SMEs and the extent of their contribution in the respective economies (Mennens, Van Gils, Odekerken-Schröder, & Letterie, 2018). Thus, substantial theories have evolved over the years in an attempt to assess the effect the sector has on the economy. This paper observes the theories that explain the emergence of SMEs in developing countries and also considers the enormous contribution of the informal SMEs in development of both developing and developed countries (Mintah & Darkwah, 2018). In addition, it also points out to the unique challenges to SMEs development and growth in developing countries and provides a strong foundation towards the formalization debate in Africa.

Africa as a continent is characterized by an unorganized and non-constitutional interaction of various economic activities in both the rural and urban areas (Wilden, Devinney, & Dowling, 2016). The informal sector, its urban precincts, have been blamed as the root cause of many problems in Africa. The informality undermines the ability of the African governments to raise revenue through taxation and leads to exploitation of the many investment opportunities available (Akinboade, 2015). Workers in the informal sector should not be vilified, since in most cases they are forced out of the formal employment into the informal sector in an attempt to survive the turbulent economic business operating environment with huge unrecorded contributions being unrecorded in the official country statistics (Fatoki, 2014). Informal SMEs in African countries play a crucial role in employment generation, stimulating economic growth and poverty alleviation (Abor & Quartey, 2010). Mennens et al. (2018) argue that most informal SMEs in Africa are engaged in retailing, trading and manufacturing, with retailing and trading mostly being found in urban regions, while manufacturing is either found in rural or urban centres. The size of the informal sector depends on a number of factors including preference, taste and consumption of local consumers, availability of the inputs used to manufacture (raw materials), and the level of development of the local and export markets (Chen, 2012; Njaya, 2015).

Arguably, developing countries in Africa face different challenges for informal SMEs development compared to the developed countries. This is further attributed to the different theories that are used to explain the emergence of the informal SMEs in Africa and the developed countries. It has been noticed that African informal SMEs face significant challenges that affect their growth and these challenges vary from country to country, but are very similar in nature. This paper reviews the theories on informal SMEs potential in the African context towards understanding the arguments put forward by various academics. The theories provide divergent views on informality encompassing the positive and negative effect on growing economies. The aim of this paper is to develop a conceptual framework that can be used in Africa for assessing how the potential of the informal SMEs can be realized. The structure of the paper is as follows, section 1: theoretical basis, section 2: results – proposed conceptual framework and section 3: discussion and way forward for the formalization debate.

1. THEORETICAL BASIS

Historical debates over the years on the size and different informal sectors have significantly crystallized into seven (7) dominant schools of thought, namely dualist, structuralist, legalist, rational choice, rational legalist theories, the recession push theory and the labor supply theory regarding its nature and composition.

1.1. The dualist theory

The International Labour Organisation (ILO) popularized this concept in the 1970s. This paradigm is of the school of thought that the informal economy is characterized by marginalized economic activities that are dominated by the poor as a source of income and a safety net in a period of economic meltdown (ILO, 1972; Hart, 1973). The theory argues that the existence of the informal sector is attributed to the unavailability of enough formal job opportunities being created to take up surplus of labor. It is identified by the government as one of the pillars for potential employment in the country (Becker, 2004). The paradigm asserts that once economic growth starts to be experienced, the informal sector will automatically reduce in size. Gerry (1987) observes this sector is characterized by Third
World handcraft workers, peasants and petty traders in underdeveloped nations who act as a buffer during recession time by providing income for retrenched laborers and a stop-over for employees seeking new jobs. Blunch, Canagarajah, and Raju (2001) argued that marginal activities in many developing countries provides between 60%-80% of total non-agricultural jobs. Sethuraman (1976) one proponent of the dualist school, argued that the informal enterprises operate as a unique sector of the overall economy with no relationship with the formal economy. The Government of China has taken positive steps in increasing their interest in the informal sector as a panacea to addressing the issues of high unemployment (Harvey & Lee, 2003; Hussain, Millman, & Matlay, 2006; Chen, 2006).

1.2. Structuralist theory

Portes et al. (as cited in Portes, Castels, & Benton, 1989) popularized the structuralist theory in the late 1970s and early 1980s. The structuralist theory argues that the informal sector should be viewed as part of the global economic system that serves to reduce input and labor costs indirectly increasing the competitiveness of large corporations (Chen, 2006). The theory in contrast to the dualist theory acknowledges the co-existence between the formal and informal sectors. It again explains the linkages, the inter-connectedness and inter-dependency that ensure that the informal sector is a necessary component of the global economy. Portes, Castells, and Benton (1989) argued that the structuralist sees the informal sector as being linked to the formal economy, while Moser (1978) observes that the informal sector employment is the marginalization of the majority of poor people and therefore advocates for the need to generate more jobs in the formal sector in an attempt to prevent the exploitation of workers in the informal sector. According to Rakowski (1994), the structuralist theory is underpinned by the critical assumptions of the neo-Marxist economic theories that assert that capitalist further their business and personal interests by exploiting the poor. Gardener argued that structuralists often explore the linkages between formalized large firms and informal small firms (as cited in Jamela, 2013, p. 22). Chen (2006) lamented that for the informal and formal economy to co-exist, there is a need for proper macroeconomic policies that ensure more equitable linkages between the two and also that the informal sector has a position on the continuum of the various economic relationships and therefore cannot be separated from the formal economy. The structuralist theory is based on a capitalist economy, where profit maximization drives the business, thereby leading to exploitation of labor through low salaries and resultantly giving birth to the informal economy.

1.3. The legalist theory

Feigie (1981) and de Soto (1989, 2000) popularized the legalist theory. Kirshner (2009) argued that the legalist theory is a result of exorbitant, inefficient, cumbersome and costly government rules and regulations, which makes it hard to comply and micro-entrepreneurs tend to go informal. The legalist enterprises participate in the formal economy to avoid the burden of high taxes and strict regulations in the informal sector. McClain, Alexander, and Jones (2008) argued that nations can take three approaches when faced with informal activities that take place in economic domains subject to regulation: ignoring its existence, making an effort to control it or legalizing it. Regulation of the economy is encouraged to ensure the market regulates its economy and also to curtail the growth of the informal sector. The theory focuses on government policies, since there is a consensus that it has a direct impact on the growth and expansion of the underground economy. It is imperative to stress the importance of government to address its laws, rules and regulations towards the informal business activity and this sector would be allowed to grow and heavily contribute towards the overall economic growth. However, Harding and Jenkins (1989), Renooy (1990) and Swaminathan (1991) argue that the informal sector entrepreneurs choose to participate there because of high levels/degrees of flexibility concerning work schedules. Berger and Buvinic (1989) argue that the main driving force for participating in the informal sector is to ensure the survival of families by ensuring the family has access to a subsistence level of income. Tedds (2010), Torgler and Schneider (2009) observe that high tax rates, perception towards the poor, quality of governance and high levels of corruption are some of the major driving forces behind the majority of enterprises operating in the informal sector. However, the empirical evidence on the
influence of taxation is mixed. Bigsten, Kimuyu, and Lundvall (2004) indicate that the incentive to operate formally is weak and, as a result, SMEs do not see any benefits from operating in the formal sector. Xaba, Horn, and Motala (2002), Hudson, Williams, Orviskas and Nadin (2012) and Chen (2006) provide some evidence of existing linkages between the informal and formal sector businesses.

1.4. The rational choice theory

Gardener observes this theory and explains the behavior of humans and has been used and adapted to fit many different fields and many disciplines in practice (as cited in Jamela, 2013, p. 26). Gardener asserts that this theory assumes that individuals always want to maximize their satisfaction given the available information on the benefits and costs of their action (as cited in Jamela, 2013, p. 26). Schneider and Enste (2000) argue that there are many factors and reasons influencing individuals to formalize or to stay informal, highlighting that though economic factors should be given more weight, personal issues should not be ignored as well. It is noted that personal factors to consider include circumstantial characteristics and personal characteristics, since the critical assumption is that the informal and formal economies are separate.

1.5. The rationalist legalist theory

Gardener argues that this theory is a combination of the rational choice and legalist theories. The ideology is that micro-entrepreneurs consider the social and opportunity costs involved before opting to go formal (as cited in Jamela, 2013, p. 27). This theory attempts to forecast and predict the effect of the informal sector on the country’s economic growth. In summary, though the informal economy plays a significant and vital role in many economies, especially in African countries, there is no agreement and unanimity in the literature on the variables/factors motivating firms to participate in the informal sector.

1.6. The recession push theory

This theory is based on the notion that the oil shocks of the 1970s cumulating into the global recession of the 1980s had a great unfavorable impact on the macroeconomic stability of developing and developed states with evidence of low economic growth, high unemployment and poor living conditions (poverty) (Uribe-Echevarria, 1993). The theory postulates that, in times of recession, large-scale enterprises were more affected than small and medium enterprises with many employees who would have suffered from the painful strategies of retrenchment, downsizing, rightsizing and realignment being forced to start their informal SMEs (Rasmussen, 1992; Kaliyati, 1994). It however, has failed to achieve desired results for Japan and Central Italy (Loveman & Sengeberger, 1991), as these countries were not negatively affected by the recession as other countries in the world.

1.7. The labor supply theory

The labor supply theory postulated by Pedersen (1998) argues that SMEs’ development is attributed as a response to the high levels of unemployment and it acts as a solution for the employees who cannot be absorbed in the formal economy. Pedersen (1998) points out that urban informal economy will significantly rise in times of recessions or financial meltdown when the size and growth of the formal sector will slow down and fail to absorb all the economically active population. However, theories have shown that when formal jobs grow small and medium enterprises, economy is likely to downsize as owners of SMEs jostle to find jobs in the formal sector and thus shows evidence of anti-cyclicality the informal sector. According to Brand et al. (1995) and Pedersen (1998), the majority of the literature review globally has taken this theory as evidence of explanation of the informal sector after the so-called Structural Adjustment Program (SAPs).

1.8. Theoretical perspectives: emergence of SMEs in developing countries

Scholars acknowledged and accepted the principle that informal SMEs are a vital factor in encouraging and achieving employment generation, economic growth and industrial growth (Sethuraman, 1997; Chen, 2006; Idris & Ismail 2007; International Labor Office, 2011; Chigwenya & Mudzengerere, 2013). There have been many theoretical interpretations concerning the emerging contemporary small-scale production globally.
Musampa (1989) indicates that in African countries, small and medium enterprises have contributed to the significant growth in many sectors. Sunita & Mead (2002) also argue that South East Asia is no exception with countries like Malaysia, South Korea, Japan, Taiwan and Hong Kong attributing the development of their manufacturing sector to SMEs development. However, Helmising indicates that serious variations regarding patterns and growth of SMEs in completely different parts of the globe tend to be different from one area to the other and also are explained by different theories (as cited in Bukaliya & Hama, 2012, p. 62).

1.9. Theoretical models linked to Africa

The ideal theories to the explanation of the serious development of SMEs in Africa is the recession push theory, the legalist theory and the labor supply theory. Zimbabwe is no exception with Kenya, Malawi, and Nigeria also falling into the pack with an explanation to the growth of the SMEs being explained by the global recession and the slow economic growth in these countries. Chigwenya and Mudzengerere (2013) point out that the informal sector is no longer dominated by the so-called urban poor and survivalist but semi-skilled, skilled, as well as educated people, as they try to supplement their meagre primary income in a recessionary economy, where high unemployment is a key characteristic as with many African developing countries. With the global financial recession and economic meltdown between the years 1998 to 2008, the formal economy in Zimbabwe has not been able to absorb thousands of school leavers and college graduates with the informal sector being seen as the major absorber of the redundant workforce (Muraya, 2004; Skinner, 2009).

Other theories that are also important in explaining the emergence of the informal SMEs in Africa are the legalist and the labor supply theories that can also be integrated into the recession theory. It is important to note that the legalist theory stresses the importance of state laws, rules and regulations towards the growth of informal business activities and conclude that in developing countries, high taxation, poor quality of governance and high levels of corruption are some of the key factors behind the majority of SMEs operating in the informal sector (Kirshner, 2009; Torgler & Schneider, 2009; Tedds, 2010). The labor supply theory points out that informal SMEs’ development is largely attributed to high rates of unemployment in developing countries (Pedersen, 1998). This view has been taken as the explanation for the growth of informal SMEs in developing countries after adopting the structural adjustment programmes (Pedersen, 1998). It is used as the solution for the many employees who cannot be absorbed in the formal sector as a response to the high levels of unemployment.

1.10. Challenges faced by the informal SMEs

Evidence (Ladzani & van Vuuren, 2002; Karedza, Sikwila Nyamazana, Mpofu, & Makurumidze, 2014; Rao, Kumar, Gaur & Verma, 2017) have shown that when many small businesses emerge, a considerable number of them fail because of many challenges. Research has shown that some fail at their infancy stage while the majority fails within a few years after start-up. Reasons cited vary from one country to the other, with the general ones in Africa being discussed.

**Accessibility to finance/credit.** Historically, SMEs have always had access to loans and capital as one of their main challenges. Limited access to finance and credit remains one of the challenges for the SMEs (Bolton, 1971; Stigliz & Weiss, 1981; Cassar, 2004; Hussain et al., 2006; Herrington & Wood, 2009; Abor & Quartey, 2010; ZEPARU & BAZ, 2014; Khan, 2015; Porumboiu, 2016).

**Lack of management and entrepreneurial skills.** Hellriegel, Jackson, Slocum, Staude, Amos, Klopper, Louw, and Oosthuizen (2008) and Lutfi, Idris, and Mohammed, (2016) point out that managerial competency is very important to the survival and growth of the informal small and medium enterprises in many countries. This view is further supported by Maseko and Mnayani (2011) who observe that lack of management skills, experience and high cost of professional accounting services are some of the main factors why new informal SMEs always fail.

**Poor location and networking.** Dahl and Sorenson (2007) and Mario (2018) argue that geographical
proximity is one of the variables that forms an enhanced environmental scanning that enables new SMEs to have access to buyers and suppliers. This view is also supported by McPherson (1995), Olawale and Garwe (2010) and Maunganidze (2013). Okten and Osili (2004) states that networking helps SMEs’ owners to tap the means of production by ensuring reduced information asymmetry, while Shane and Cable (2002) further points out that networking ensures the SMEs’ legitimacy, which positively influences the firm’s accessibility to borrow from outside sources.

Poorly defined legal and regulatory framework. Government legal and regulation on businesses is an important issue of concern for all economies globally (European Commission, 2010; Chen, 2012). The general belief is that regulation is a necessary evil meant to provide stable trading conditions and to develop some high degree of business trust, which can create a conducive environment for SME development (Welter & Smallbone, 2006; Atherton et al., 2008; Charoensukmongkol, 2016). World wide deregulation, over-regulation and lack of regulation are bad for the informal sector and its respective employees. There is a need to rethink regulations (sector-specific) to determine proper regulations for the informal economy and the components of the informal employment.

Technological capabilities. Technological development is a key element in ensuring that SMEs can be able to compete in both the domestic and international markets (Goldstein, Pinaud, Reisen, & Chen, 2006). Lall (1993) points out that technological activities should be imagined by thinking beyond the firms, as a single SME does not have the necessary knowledge to introduce new products and processes thus the need to interact with home and foreign players in creating and advancing the technology being used. A study by Levy, Berry, and Nugent (1999) concluded that SMEs, both formal and informal, build their technological capabilities by drawing from international exhibitions, licensing agreement or from vertical integration links as in the case of Korea and Japan, respectively. African SMEs have exhibited in most cases low levels of technological efforts and linkages, which have hindered these firms’ capacity in competing on the international market (McCormik et al., 1997; Levy Berry, Nugent, & Urata (1999).

Government policy towards SMEs. GATT (1994) and Charoensukmongkol (2016) state that government’s policy towards SMEs is considered one of the important variables taken into consideration when looking at the possibility of unlocking the informal SMEs’ potential. Literature shows that government support differs significantly across the different continents with some governments creating many barriers to SMEs’ development in the form of excessive regulation and red tape. Globally, many states and governments have established agencies and institutions in an attempt to support and try to assist SMEs with the overall aim being to create an enabling and conducive environment for SMEs’ development (Mahembe et al., 2011; Naicker, as cited Smith & Watkins, 2012). Studer et al. (2006), Mutula and Brakel (2006), Madrid-Guijarro et al. (2009), Okpara (2011), Peters and Naicker (2013) argued that underdeveloped, undeveloped and many failed small and medium enterprises are a result of minimum government support, which hinders its growth and development.

2. RESULTS: PROPOSED CONCEPTUAL FRAMEWORK

The proposed conceptual framework developed for this paper is based on the Fishbone diagram developed by Kaoru Ishikawa (1986) and literature review on the key constructs that have been hindering informal SMEs performance, development and realization of their full potential in developing countries. In this diagram, the challenges are identified as problems that need to be solved. Literature review identified six (6) major constructs, in identifying the main challenges in informal SMEs development. The six (6) factors are (1) accessibility to finance and/or credit (2) lack of management and entrepreneurial skill (3) poor location and networking (4) technological capabilities, (5) government policies towards the informal SMEs and (6) poorly defined legal and regulatory frameworks. The proposed conceptual framework is the first of its kind to be developed in Africa in an attempt to consolidate the above constructs into a single workable framework.
2.1. Discussion of the proposed conceptual framework

The proposed conceptual framework has been developed after taking into the account all the unique challenges identified in literature review in both developed and developing economies.

2.2. Challenges faced by the informal SMEs

2.2.1. Conditions that Hinder Informal SMEs to release maximum potential

Limited accessibility to finance, lack of access to management and entrepreneurial skills, poor location and networking, technological capabilities, poor government policies towards SMEs and poorly defined legal and regulatory framework have been identified in literature review as the main challenges being faced by the informal small to medium enterprises. These factors are seen as the conditions that hinder informal SMEs to release their potential.

2.2.2. Conditions Conducive for Assessing Informal SMEs potential

The proposed framework to ensure that informal SMEs realize their full potential will be premised on the basis that the informal SMEs will have tailor-made access to finance/credit, that government and private sector will provide start-up business support and mentorship programs and capacity building and financial inclusion framework, stronger technological capabilities, friendly government policies towards SMEs and a strongly defined legal and regulatory framework.

2.3. Government policies towards SMEs and a strongly defined legal and regulatory framework

Literature confirms that government regulation on businesses is an important tool for the growth and performance for all economies (European Commission, 2010). World Bank (1992), on the other hand, points out that a good legal and regulatory framework makes econom-
ic transaction easier, reduces uncertainty and helps the markets to realize their full potential. Charoensukmongkol (2016) also observes that government support in many different ways is critical to the international performance of SMEs. However, Peck, Jackson, and Mulvey (2017) highlights that poorly defined regulation can have adverse effects on the growth and development of SMEs.

3. RECOMMENDATIONS

The proposed conceptual framework is a reflection of the key constraints faced by the informal SMEs and the main solution to their challenges is ensuring formalization of the informal SMEs by ensuring that developing countries have addressed the following key pillars:

- Developing a supporting legal and regulatory framework.

Developing effective legal and regulatory framework that promotes informal SMEs by avoiding restrictive registration requirements and allowing many microfinance institutions to enter the market.

- Developing effective government policies and support mechanisms.

Government policies and initiatives should be properly designed and better evaluated to ensure informal SMEs’ growth and development. Policy analysis reflects that government interventions may significantly help to stimulate the take-off of the informal SMEs.

- Developing a registration framework.

A registration framework for informal SMEs with relevant authorities and government departments should be provided. This should ensure that informal SMEs get operating licences easily.

- Developing favorable financial infrastructure.

Establishing a solid and favourable infrastructure to enable an improved accessibility of finance by the informal manufacturing SMEs.

- Providing appropriate and up-to-date technology.

Provision of an appropriate technology is a catalyst for ensuring the growth and development of the informal SMEs. Use of state of the art technology leads to improved products, reduced production and operating costs and improved efficiency.

4. DISCUSSION AND WAY FORWARD FOR THE FORMALIZATION DEBATE

This paper shows the significance of the informal SMEs as one of the keys that can fuel employment generation, economic growth and development in Africa at large. This implies that there is a great need for the informal economy and its workforce to be fully recognized despite lack of overarching policy interventions to attend to their problems as indicated in the proposed conceptual framework (Chen, 2012). There should be various interventions to be considered, and these interventions needs to be tailored and designed to meet the specific country constraints, wants and needs of different groups of the informal economy. Economic and social policies ought to be revisited regarding their impact on the informal sector and the respective parts (World Bank, 1995). Most policies have a positive and negative impact on the formal economy, and it is in the interest of the government to monitor the impact of the different policies on the different classes of the informal sectors and attempts to address the negative impacts. There is serious need to improve the measurement of informal employment and informal SMEs in official economic statistics.

In Africa, fundamentally, what is required is a new economic paradigm in the form of a model that embraces both the traditional and modern SMEs in the informal and formal economy. Chen (2012) argues that what is needed is a model that allows the micro-enterprises and least powerful workers to be able to operate alongside the large corporations and the most economic players. Many policy debates on the informal economy have asked the question about how to formalize the informal economy. Scholars came up with differ-
ent notions of what formalization of the informal economy means with some arguing that it merely means shifting the informal workers into the formal wage/salaried jobs, with others arguing that it means registering and taxing informal enterprises (Hussmanns, 2004; Gono, 2006; Chen, 2012). The last group where the informal SMEs are already paying the taxes and/or licence fees being formal means gaining access to legal and social protection, as well as support services (skills and business training) and access to be represented in critical rule-setting, policy-making and trade union collective bargaining processes.

It is important to understand that formalization has no universally accepted definition and therefore has different meanings and implications for different categories of the informal sectors. In addition, it is of paramount importance to ensure that formalisation offers the benefits and protections that are attached to becoming formal and does not only increase the costs of becoming formal (Chen, 2006). In the case of the self-employed going formal, it should not imply just obtaining a trading license, registering their accounts and paying taxes as these represent the costs of entry into the formal sector. The question would be what is it that they would like to receive as benefits of going formal in return for paying these high costs? Among the benefits should be tax breaks and incentive packages, legal ownership of their place of business and means of production, membership in trade associations, protection against creditors and clear bankruptcy and social protection. However, it is important to appreciate that formalization has different dimensions beyond the benefits above and policy-makers should acknowledge and recognize these various dimensions of formalisation and the fact that formalisation is not therefore a one-step process, but rather an ongoing process of extending benefits of formalization incrementally to the informal workers.

Summarily, the informal sector and workforce in Africa need to be respected and valued for their contributions and integrated into the mainstream for advanced economic planning and legal frameworks. Realisation of the full potential of the SME would lead to employment generation, which would create more jobs in the operating environment. With more jobs being created in the economy, the economy will experience high economic growth in the form of an increase in Gross Domestic Product. This will, in the long run, lead to economic development and the conversion of the informal SMEs into formal businesses. Through addressing the challenges faced by the informal SMEs through the various interventions strategies, the full potential of the informal SMEs would be unlocked.

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