

**TRANSITING FROM THE INFORMAL TO FORMAL BUSINESS:  
MOTIVES, CHALLENGES AND THE COPING MECHANISMS OF  
SELECTED TRANSITED BUSINESSES IN THE BLOEMFONTEIN AREA**

**BY**

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## DECLARATION

I, ROLLINE ESTELLE NDJIKE TASSIN EPSE FONGWA student number 212086804 hereby declare that this dissertation submitted to the Central University of Technology, Free State for MTECH: Business Administration is my own original work and that this work has not been previously submitted for any degree or examination in any other University. I further cede copyright of the dissertation in favour of the Central University of Technology, Free State.

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## **DEDICATION**

To God, the giver of life  
The source of knowledge and wisdom  
My source of inspiration

Now and forever!

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## **ABSTRACT**

This exploratory study seeks to contribute to the theoretical and empirical understanding of the transition of small businesses from the informal to the formal sector. It builds on the role of the informal sector as “engines” for economic and socio-cultural development. Using selected businesses in the Mangaung area of the Free State province as case studies, this study investigates the motives for transition of informal businesses to the formal sector in South Africa, challenges encountered in the process of formalisation and the coping strategies relied upon to deal with challenges encountered in the process of formalisation.

Key indicators were identified from the literature and were further developed for investigation. A qualitative approach was used for the collection of data from selected transited businesses in the Bloemfontein area using semi-structured interviews.

Findings from the study suggest that the decision by small business owners to formalise is motivated by their desire to grow and expand their businesses; access to proper banking services; and to access government contracts and tenders.

The results also reveal that the quest for growth is however hindered by long queues endured by business applicants during the process of formalisation; lack of adequate and relevant information on the process of formalisation; coupled with the lack of government support for informal businesses’ transitioning to the formal sector. Findings further revealed that adequate information on the process of formalisation and self-trust are key coping mechanisms needed by small business owners to successfully progress/ transit to the formal sector.

Based on these findings, the study recommends that government both provincial and national play a more proactive role in regulating the informal economy by creating an environment conducive for their growth and development, and facilitating their transition

to the formal sector. Informal small business owners also must be provided with information on the process of formalisation and of the existing government structures put in place to support businesses in their transition phase.

# CHAPTER 1: INTRODUCTION TO THE STUDY

## 1.1 INTRODUCTION

This study examines informal businesses that have successfully transitioned to the formal sector. Informal businesses, also collectively known as the informal sector, form an integral component of the segment globally known as the Small, Medium, and Micro Enterprise (SMMEs) or the SMME sector. Unlike in the past, informal businesses have of late been featuring prominently in policy and research agenda especially in developing countries such as South Africa presumably because of the important role of the SMME sector in socio economic development of countries, regions and localities (Dzansi and Pretorius, 2009:459).

Generally speaking, informal businesses are micro in nature – a feature that enables them to require low start-up capital, itself the easiest entry point into mainstream economy especially for the majority of formerly underprivileged South Africans who lack: (i) education to gain formal employment, or (ii) the financial resources to start formal businesses. According to Rolfe *et al.*, (2010:1), South Africa's business sector is unable to absorb the growing number of entrants into the labour market every year. Incapable of finding work in the formal economy, many South Africans resort to the informal sector often in the same line of business. However, the same micro nature exposes informal businesses to diseconomies of scale. Thus, it is logical to expect business owners who are ambitious and who think strategically to desire formalisation of their businesses over time. This is particularly so given the corporate value of formalisation such as the protection of workers and legal recognition, enforceable commercial contracts, access to state protection, access to credit and bank loans and freedom from corruption and embarrassment (John and Nina, 2011; Maliyamkono *et al.*, 2012 and Martha, 2012). The goal of this research is to comprehend the procedures and processes necessary for successful formalisation of informal businesses in the South African context.

This introductory chapter provides an introduction to the study, including the need for formalisation, justification of the study, problem statement, research questions, definition of key concepts, theoretical framework, conceptual framework, methodology, ethical considerations and concludes with the delimitations of the study.

## **1.2 THE NEED FOR FORMALISATION**

From policy makers and government viewpoint, formalisation of informal businesses is crucial to the national economy for several reasons: financial injections into the economy through firm registrations, contribute to circular flow of income and lead to reduced distortions when measuring national accounts (GNP) (Gërxhani, 2003: 298). Economic distortions arise when informal businesses evade tax and hide their financial accounting performance indicators leading to difficulties in calculating GNP and imposing appropriate tax regimes.

While tax avoidance is often advanced by informal businesses as their principal motivation for remaining informal, the desire for firm growth, to the contrary, often triggers quests for the formalisation of businesses. Formalisation is vital for growth because banks, for example, are keener to finance a formal business than informal ones due to several considerations such as sustained book keeping, transparency of their businesses processes, access to contractual opportunities and lower risks of defaults on loans advanced (International Finance Corporation, 2013). Opportunities for expansion into a viable business are therefore severely limited by access to finance though not impossible (Rolfe, Woodward, Ligthelm, and Guimarães, 2010:7) when the business remains informal. Whilst reasons such as access to finance, legal recognition and access to bank loans may make formalisation attractive to informal businesses, it is important to mention that, it will be preposterous for anyone to suggest that the transition will be smooth sailing. Instead, one should expect challenges.

### **1.3 IMPORTANCE/JUSTIFICATION FOR THE STUDY**

Barnard, Kritzinger and Kruger (2011:111) claim that “SMMEs in South Africa play an increasingly important role in stimulating economic activity, growth and employment creation”. This view is supported by Rootman and Kruger (2010:107) who point out that “SMMEs are important contributors to the economy as they provide employment opportunities and create economic wealth”. Another advantage of SMMEs is their contribution to the country’s gross domestic product (GDP), which triggers economic development. In the South African context, it is generally estimated that SMMEs contribute 50% of all the formally employed people whilst contributing about 42% of the country’s gross domestic product (GDP). Based on the aforesaid, it is important to reiterate in Michelle’s (2011:10) words that “while the contribution of small businesses is often ignored, it should not be so as SMMEs are set to lead economic recovery by helping to reduce unemployment levels across the globe, especially in developing countries”.

### **1.4 PROBLEM STATEMENT**

#### **1.4.1 PROBLEM BACKGROUND**

It is estimated that there are between 1 and 2.3 million informal businesses in South Africa, which contribute between 7 and 12 per cent to South Africa’s Gross Domestic Product (GDP) (Von Broembsen, 2007:11). Considering the fact that formalising can enable informal businesses to grow, develop new markets, increase market share, and position themselves strategically in the market (Wickham, 2001:78; Dzansi, 2004:48), the formalisation of informal businesses should naturally become a sustainable priority for most informal businesses in South Africa.

A pilot survey by the researcher in Mangaung, suggest that although many informal businesses would like to formalise, they perceive the process as cumbersome. The prime challenges informal businesses often raised with regard to this transformative /“conversion” journey to formalisation include: the pressure to pay taxes, complicated



labour laws, and complicated corporate compliance issues. In light of these hurdles, the convenient place to operate from becomes “remaining informal.” The above anecdotal evidence from the researcher’s pilot survey is corroborated by Leino (2009:3) who points out that the chief reason cited by informal firms for remaining informal amongst a number of other challenges is the taxes on registered businesses. Thus, there are motives that drive informal businesses to formalise or not to.

The information from the informal conversations although insightful, remains speculative. Businesses in the informal sector need to be rigorously tested in order to fully comprehend the procedures involved in order to successfully make the transition from the informal sector to the formal in South Africa.

#### **1.4.2 THE PROBLEM**

The problem is that without a systematic study like this one, the motivations for formalisation of informal businesses; the associated challenges of this process; and the personal traits that informal business owners draw on most in dealing with challenges of transition may not be sufficiently grasped. In addition, it will be difficult to identify ways of overcoming these challenges.

#### **1.5 RESEARCH QUESTIONS**

The above problem statement leads to the questions:

1. What are the main motivations for the decision to formalise previously informal businesses?
2. What challenges do the transited businesses experience in their transition to the formal sector?
3. What personal traits do informal business owners draw on in dealing with challenges of transition?

4. What strategies can be put in place to reduce if not eliminate the challenges of transition from informal to formal business?

## **1.6 DEFINITION OF KEY CONCEPTS**

### **1.6.1 SMMES**

Dzansi (2004:33) states that there is no single universally acceptable definition for SMMEs since it differs across countries and even within countries, For example, the Organisation for Economic Co-operation and Development (OECD) (2005:2) views SMMEs as firms with fewer than 500 employees. However, in the South African context, the overriding definition is the one contained in the National Small Business Act, 1996. According to this Act, a small business is: “A separate and distinct business entity, including co-operative enterprises and non-governmental organisations, managed by one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or sub-sector of the economy and which can be classified as micro-, a very small, a small or a medium enterprise”. The Act further classifies the businesses as *micro*, *very small*, *small*, and *medium* according to a mix of criteria such as *sector*, *turnover*, *asset base*, and *number of employees*.

### **1.6.2 INFORMAL BUSINESS**

Like SMMEs, several definitions have been coined for the informal sector (the collection of informal businesses). They have been defined as: “unorganised and mostly legal but unregistered economic activities that are individually or family owned and use simple, labour intensive technology” (Barker, 2003:19). Statistics South Africa (STATSA) (2003:13) defines informal businesses as “unregistered businesses run from homes, street pavements or other informal arrangements.” (Portes and Haller (2005:2) define them as “enterprises that are not legally regulated by the institutions of society in a legal and social environment in which similar activities are regulated”. For the purpose of this study, Portes and Haller’s (2005:2) definition is adopted since it appears to capture the

essence of most definitions. The above definitions of the informal business, in particular (unorganised, unregistered and individually owned) makes it much easier to understand why such businesses would want to formalise their operations.

## **1.7 THEORETICAL FRAMEWORK**

Like Wickham (2001:77), Dzansi (2004:48) argues that SMMEs make more impact on society when they adopt strategic objectives of growth; market development; increased market share; and market positioning. But adopting any of these strategic postures will require formalising the business. Firm growth, for instance, will require any informal micro enterprise to raise capital and no investor or lender could be willing to inject money into an unregistered business because there is no traceability. Thus from a strategic management or strategic entrepreneurship perspective, it makes sense for an informal business to formalize its operations.

## **1.8 CONCEPTUAL FRAMEWORK**

As captured in Figure 1 below, it can be argued that long term or strategic **motives** drive informal business owner/manager's decision to formalize or not to. These **motives** are the reasons for formalization which amongst others may include the vision and ambition of business owners to grow their business. Should the owner/manager decide to formalize, there are challenges to contend with (USAID, 2005:17). **Challenges** of formalisation consist of inter alia complex regulatory processes, bureaucracy and tax issues (USAID, 2005:17). Further, it is argued that the ability of an informal business to successfully negotiate these challenges will depend on certain background and personal traits of owner managers. That is, in the end, only businesses whose owners/managers possess the right attributes to overcome the challenges will be able to transit (graduate) to a formal business.

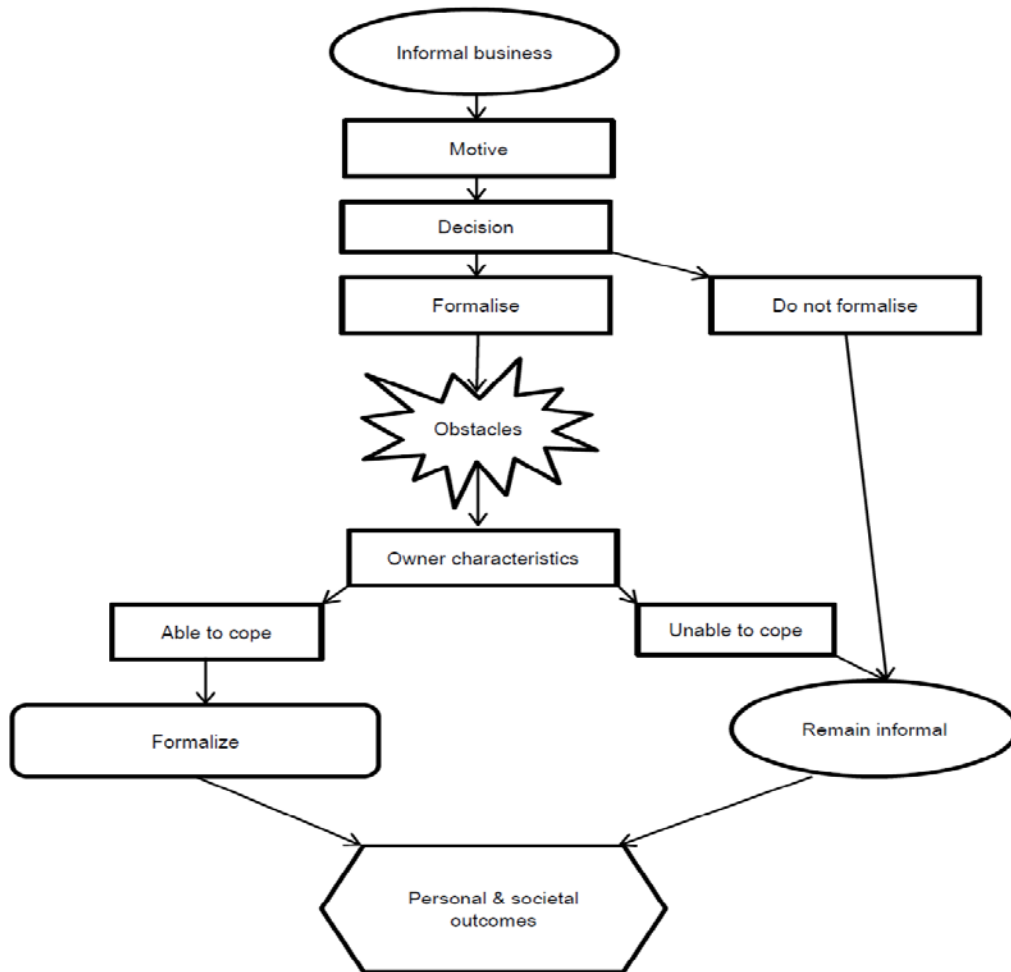


Figure 1.1: Transition of informal to formal business

On the other hand, businesses whose owners do not possess the right attributes may not be able to cope with cumbersome processes of formalisation, hence will remain informal. **Attributes** that enable owners to overcome challenges may include inter alia: entrepreneurial orientation, strategic orientation, level of education, networking abilities (Solymossy, 1998; Shane, 2005). The ‘graduated’ businesses will, all things being equal, be able to derive benefits associated with formalisation such as easier access to finance. At the same time there will be benefits to society through increased job creation, tax contributions and social responsibility contributions. When a business fails to ‘graduate’

hence remains informal, it will continue to provide owners with only survival income whilst depriving state of benefits such as taxes for the state.

## **1.9 METHODOLOGY**

### **1.9.1 RESEARCH PHILOSOPHY AND DESIGN**

The ontological position taken in this research was that “people’s knowledge, views, understandings, interpretations, experiences, and interactions constitute meaningful properties of social reality” (Mason, 2007: 63). That is, social reality is best captured through the views, understandings, interpretations, and experiences of actors themselves. Thus, to understand the informal-to-formal business transition process, it is ideal to see it through the lenses of the “graduated” owners. Consistent with this ontological position, the interpretivist approach and qualitative design were adopted in executing this research. Specifically, the research approach involved talking interactively with participants through semi-structured questions, listening and interpreting their responses/accounts of events (Mason, 2007: 64) to understand their transition from the informal to the formal sector.

### **1.9.2 POPULATION AND SAMPLING**

The population for this study was all ‘graduated’ (transited) businesses in the Bloemfontein area. Neuman (2000:196) argues that sampling is a less rigorous issue in qualitative studies than in quantitative studies since understanding of the phenomenon is more important than the sample size and the method of sample selection. Neuman (2000:196) observes that:

“Qualitative researchers focus less on a sample’s representativeness or on detailed techniques for drawing a probability sample. Instead, they focus on how the sample or small collections of cases, units, or activities illuminate social life. The primary purpose of sampling is to collect specific cases, events or actions that can clarify and deepen understanding”.

Guided by this insight, a convenience sample of 18 identified businesses which had succeeded in “graduating” to the formal sector formed the nucleus of respondents/participants. The names of these business “graduates” were obtained from the Free State Development Corporation (FDC), one of the institutions that assist businesses in their registration process in South Africa. The reason for selecting this group was that these businesses had first-hand experiences of the formalisation processes and hence were deemed to provide information-rich accounts of these processes. Although 18 participants were considered large enough for a qualitative study (Neuman, 2000:196), snowball sampling was also used to identify 11 additional participants.

### 1.9.3 DATA COLLECTION

Primary and secondary data were used in this study. In terms of primary data, Mason (2007:65) advises that in cases where epistemological assumptions favour contextual, situational and interactional knowledge and evidence gathering, semi-structured interviewing is most appropriate. Secondary data were collected from policy documents and related literature. For primary data collection, interviews were held with owners of ‘graduated’ businesses using semi-structured questions to provide deep accounts of how they negotiated their formalisation *journey*. The researcher used participant’s experiences, interpretations, perceptions, meanings and understandings (Mason, 2007:56) of the transition process as the source of primary data. The questions were based (but not exclusively) on the insight provided by the literature review (theory) on common challenges small businesses encountered in their formalisation process.

### 1.9.4 DATA ANALYSIS

Interpretive reading (Mason, 2007:148) which required that primary qualitative data collected from respondents be transcribed, analysed and categorised into different themes, was adopted in this study. Essentially, the researcher constructed meaning from data collected from respondents by transcribing the data and categorising into different

themes. Regarding secondary data obtained from SMME development agencies, content analysis was used since it was most suitable for analysing communication data (Babbie and Mutton, 2011:383).

### **1.10 ETHICAL CONSIDERATIONS**

This research was conducted bearing in mind all possible ethical implications of social research. Particularly, the information obtained was exclusively used for the purpose of the research; there was no disclosure of the identities of respondents; and informed consent was sought from all participants before soliciting for data from them.

### **1.11 DELIMITATIONS OF THE STUDY**

The research focused on firms that have already moved from the informal to the formal sector. This means that views of firms that have failed to make it or are in the process was not captured. This approach was a deliberate one as the intention of the current study was to understand how the 'graduated' businesses went about their business. As such, the usefulness of the current study is not compromised.

### **1.12 CHAPTER OUTLINE**

The current chapter articulated the need for formalisation, justification of the study, problem statement, research questions, definition of key concepts, theoretical framework, conceptual framework, ethical considerations and concluded with the delimitations of the study. **Chapter 2** is divided into 2 broad focal areas namely SMMEs and the informal sector and reviews the literature on these broad focal areas. **Chapter 3** presents the methodology applied to the study. **Chapter 4** deals with data analysis and the presentation of findings. The last Chapter (**Chapter 5**) enunciates the conclusion and recommendations to the government and business owners, and provides research limitations, areas for further research and concluding remarks.

## CHAPTER 2: LITERATURE REVIEW

### 2.1 INTRODUCTION

This Chapter concentrates on the smaller businesses which include micro, small, medium enterprise (SMMEs). The criteria for determining SMMEs in this study will be adopted by that provided by the National Small Business Act of 1996 as amended in 2003 and 2004. This act provides the most generally applied definitional framework in the context of South Africa. Below are the categories of small businesses according to size provided by the National Small Business Act of 1996 as amended in 2003 and 2004.

- i. Medium enterprises employ 120 to 200 persons depending on industry;
- ii. Small enterprises employ up to 50 persons;
- iii. Very small enterprises employ 10 to 20 persons depending on industry; and
- iv. Micro enterprises employ up to 5 persons.

For convenience, the literature review is divided into two broad focal areas namely SMMEs in general and the informal sector, also referred to in this study as informal businesses.

Before starting the literature review, it needs to be pointed out that internationally, the acronym SME is used to refer to small and medium enterprises while in South Africa like in the European Union, SMMEs is used (Katz and Green, 2011; Agbobli, 2013:32). Because this study is conducted in South Africa, in accordance with the South African norm, the term SMME is used to refer to what others will call SMEs.

The definition of SMMEs and conceptualisation of SMMEs remain contested areas of research globally (Agbobli, 2013:32) and no universally accepted definition for SMMEs exists even within one country. It is therefore considered necessary to examine extant definitions of SMMEs in order to arrive at a working definition for adoption in this study.



## **2.2 PERSPECTIVE ON SMME ISSUES**

### **2.2.1 DEFINING SMMES**

Defining SMMEs is not an easy task. The literature search revealed a plethora of definitions. These definitions do not only differ between countries but even within countries, there are noticeable differences. An attempt is however made to provide a working definition. In this regard, it is considered appropriate to first explore inter-country definitions.

#### **2.2.1.1 The United States (US)**

Small business in the US is described by the U.S. Small Business Administration (SBA, 2013) as, small businesses which must be independently owned, employ a maximum of 500 persons and must not be dominant in their field of operation nationally. The classification of small businesses also varies in the US as it is referred to as Small and Medium Business and this classification is significant as this determines which businesses are eligible for government financial assistance.

#### **2.2.1.2 The European Union (EU)**

Drawing on headcounts, balance-sheet value and turnover as guiding criteria, the EU defines small businesses as enterprises that employ a maximum of 250 persons (Stokes and Wilson, 2010:4). This definition is summarised in a tabular form and presented in Table 2.1.

In the EU, the established quantitative thresholds are important because they are used for trade policy purposes in this region and as qualification criteria for small businesses to obtain state guaranteed loans for business operations.

Table 2.1: The EU small business thresholds

Size of class	Headcount	Turnover	OR	Balance sheet total
Medium	50-249 (<250)	< € 50m		< € 43m
Small	10-49 (<50)	< € 10m		< € 10m
Micro	0-9 (<10)	< € 2m		< € 2m

Source: European Commission (2009:3).

### 2.2.1.3 The United Kingdom (UK)

The UK definition of small businesses only incorporates small and medium enterprises. According to the Companies Act 2006 in UK, medium enterprises are defined as enterprises employing a maximum of 250 employees and having a turnover of £25.9million. The act also defines small businesses as businesses employing not more than 50 persons. The UK's definition of small businesses are summarised in Table 2.2 below.

Table 2.2: The UK small business definition

Size of class	Turnover	Balance sheet	Employees
Small business	£ 6.5m	£ 3.26m	50
Medium	£ 25.9m	£ 12.9m	250

Source: The UK Companies Act (2006)

### 2.2.1.4 South Africa

In South Africa, SMMEs are normally defined in accordance with the National Small Business Act of 1996 as amended in 2003 and 2004 which defines SMMEs as: "A separate and distinct business entity, including co-operative enterprises and non-governmental organisations, managed by one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or sub-sector of the economy and which can be classified as micro, a very small, a small or a medium enterprise". The National Small Business Act of 1996 (as amended in 2003 and 2004) categorises SMMEs into distinct groups, namely; survivalist, micro, very small, small and

medium micro-enterprises. To be more specific, the National Small Business Act of 1996 (as amended in 2003 and 2004) provides the following classifications for SMMEs in South Africa.

- Businesses with fewer than 200 employees, with an annual turnover of less than 40 million rands and gross asset value of less than 18 million rands are regarded as medium enterprises.
- Businesses with less than 50 employees, with less than 25 million rands in total annual turnover and less than 4 million rands gross asset value as small enterprises.
- Businesses belonging to the 'very small' category are those with less than 10 employees, with less than 4 million rands annual turnover and less than 1.8 million rands gross asset value.
- Businesses with less than 5 employees, with less than 0.15 million rands annual turnover and less than 0.10 million rands asset value are regarded as micro.
- Businesses with no paid employees, with less than the minimum income standard, asset value or poverty line belong to the survivalist.

These classifications are presented in Table 2.3 below.

Table 2.3: Schedules of SMMEs in South Africa

Sector /sub-sector	Size of Class	Total number of full-time employees	Annual turnover	Total gross asset value
Agriculture	Medium	100	R5m	R5m
	Small	50	R3m	R3m
	Very small	10	R0.50m	R0.50m
	Micro	5	R0.2m	R0.10m
Mining and Quarrying	Medium	200	R39m	R23m
	Small	50	R10m	R6m
	Very small	20	R4m	R2m
	Micro	5	R0.20m	R0.10m
Manufacturing	Medium	200	R51m	R19m
	Small	50	R13m	R5m
	Very small	20	R5m	R2m
	Micro	5	R0.20m	R0.10m
Electricity gas And water	Medium	200	R51m	R19m
	Small	50	R13m	R5m
	Very small	20	R5.10m	R1.9m
	Micro	5	R0.20m	R0.10m
Construction	Medium	200	RR26m	R5m
	Small	50	R6m	R1m
	Very small	20	R3m	R0.50m
	Micro	5	R0.20m	R0.10m
Retail and motor Trade and Repair services	Medium	200	R39m	R6m
	Small	50	R19m	R3m
	Very small	20	R4m	R0.60m
	Micro	5	R0.20m	R0.10m
Wholesale Commercial Agents & allied Services	Medium	200	R64m	R10m
	Small	50	R32m	R5m
	Very small	20	R6m	R0.6m
	Micro	5	R0.20m	R0.10m
Catering, Accommodation And other Trade	Medium	200	R3m	R3m
	Small	50	R1m	R1m
	Very small	20	R1.9	R1.9m
	Micro	5	R0.10	R0.10m
Transport Storage and Communications	Medium	200	R26m	R6m
	Small	50	R13m	R3m
	Very small	20	R3m	R0.60m
	Micro	5	R0.20m	R0.10m
Finance and Business services	Medium	200	R26m	R5m
	Small	50	R13m	R3m
	Very small	20	R3m	R0.50m
	Micro	5	R0.20m	R0.10m
Community social and Personal Services	Medium	200	R13m	R6m
	Small	50	R6m	R3m
	Very small	20	R1m	R0.6m
	Micro	5	R0.20m	R0.10m

Source: The National Small Business Act of 1996 as amended in 2003 and 2004

For the purpose of this study, SMMEs are defined in accordance with the National Small Business Act of South Africa of 1996 (as amended in 2003). While the classification of SMME differs across countries, one aspect about SMMEs in which there is much consensus is the contribution that the sector makes to social and economic welfare of citizens and economic and social-cultural growth of towns, regions and countries. The next section provides a broad overview of the various ways in which SMMEs have made this contribution.

## 2.2.2 CONTRIBUTION OF SMMEs TO SOCIO-ECONOMIC WELFARE

This section is discussed in two subsections. The first section provides a global picture while the subsequent section focuses on the South African context.

### 2.2.2.1 Global context

A study on the global economy conducted by the Edinburg Group (2012:7) revealed that although SMMEs constitute more than 95% of enterprises across the world, they account for approximately 60% of private sector employment. A report on SMMEs in Japan compiled by the Economist Intelligence Unit (2010:3) reveals that among the industrialised countries, Japan has the highest proportion of SMMEs and these employ more than 99% of the total working population of Japan.

In high-income countries, the backbone of the economy is the SMME sector. Though making a lesser percentage of employment, the SMME sector also makes a critical contribution to employment and GDP in low-income countries. High income countries contribute 66% of employment as opposed to 78% of employment in low income countries and 13% to GDP as opposed to 47% respectively. Practitioners and researchers seem to agree that SMMEs are crucial contributors to economic growth and job creation in most countries (Edinburg Group, 2012; Dalberg, 2011; Organisation for Economic Co-operation and Development [OECD], 2006).

In most developing and emerging economies, the SMME sector has played significant roles in achieving development targets. In Malaysia, the sector contributed about 33% to national GDP of 2011 and is expected to make a 40% contribution by 2020 through what has the Malaysian government calls the SMME 'master plan' (Stats Online, 2013).

In India, though SMMEs contribute only 17% to national GDP, they employ more than 40% of the workforce thus providing some form of sustenance to lower middle class and working class population groups (Adarsh, 2011). Padmadinata (2007) notes that in Indonesia SMMEs made a total contribution of 99.9% of total enterprises in the country. This amounted to close to 50million SMMEs, which were created in the previous year, providing, work for more than 85 million people (Pandya, 2012). The next section discusses the national and provincial contribution of SMMEs in South Africa.

#### 2.2.2.2 National context (South Africa)

Abor and Quartey (2010:219) estimate that 91% of formal entities are SMMEs in South Africa. Tshabalala (2007:1) argues that SMMEs make an important part of any economy. With more than 91% of all businesses in South Africa being described as SMMEs, contributing about 40% of all economic activity in the country, their importance remains critical to the socio-economic growth of the nation.

Stats Online (2013) mentions that the unemployment rate in South Africa currently stands at 25.2 % and SMMEs have the ability to reduce unemployment and eliminate poverty through job creation. The provision of these jobs has a multiplier effect such as employment and innovation on the workers who depend on these salaries.

As earlier discussed, SMMEs also contribute to the GDP of a country or region. In the South African context, it is estimated that SMEs contribute 42% of the country's GDP. This occurs through SMEs' contribution of up to 50% of all formal employment (Ayyagari et al., 2005). The results of a comparative study on issues of SME development in Ghana

and South Africa however revealed that SMMEs in South Africa contribute about 52% to 57% of GDP (Abor and Quartey, 2010:219).

The above section has provided evidence from the literature of the contribution of SMMEs to economic growth. What remains of interest to this study is the level of support for the SMME sector. SMMEs need support if they are to make a positive contribution to the socio-economic development of any country. The section below presents a review of the literature on SMME enabling environment at a global level as well as a focus on the South African SMME support environment.

## 2.2.3 SMME ENABLING ENVIRONMENT

### 2.2.3.1 Global perspective

In Vietnam, the Agency for SMME Development (ASMED) (2008:3) together with the government and the Ministry of Planning and Investment presented some policies on the development of support for SMME. The main aim of these policies is to increase the number of SMEs and strengthen the competitive capacity for SMMEs to create more jobs; take advantage of investment resources; contribute to the country's economic development; social stability, modernization and industrialization.

According to ASMED (2008:4), the first legal framework for SMME development support in Vietnam was the systematic implementation of policies on SMME promotion and development support to improve the status and function of SMMEs in social stability and economic development. ASMED elaborates that policies on SMME support include:

- Investment promotion;
- Credit guarantee fund for SMME;
- Premises;
- Market and competitive capacity;
- Export promotion; and
- Information, human resource consultancy and training.

In order to strengthen the implementation of SME support policies in Vietnam, a regulation on the establishment and operation of credit guarantee funds for SMEs was provided by the government. Furthermore, in order to facilitate access to finance for SME development, the state bank submitted to the government the proposal on credit policies for disadvantaged areas. In response to this proposal submitted by the state bank, the Vietnam government issued the Resolution No. 06/2006/NQ-CP in 2006, which provides guidance on the implementation of SME support policies. The State Bank has also established the private credit fund to support commercial banks in lending decision making. These initiatives have been successful in facilitating access of SMEs to finance through the provision of Credit Guarantee Fund, SME Finance Fund, Venture Capital Fund, Bank lending and payment package to provinces and cities of Vietnam (ASMED, 2008:16).

In China, Lei (2008) suggests that the support given to SMMEs is designed in accordance with the SMME Promotion Law, whose main considerations cover the payrolls, revenue and total assets of enterprises. According to Lei (2008), the SMME promotion law applies to industrial sectors including mining, manufacturing, power, gas and water utilities, construction, transportation and posts, wholesale and retail, and hotels and restaurants.

As a result of this law which aimed at supporting SMMEs in China, the Chinese government dynamically developed business support service organisations and provided efficient, high-quality and convenient services to SMEMs. Examples of such services include a policy issued by the People's Bank of China and the China Banking Regulatory Commission to encourage banking sectors to improve SMME financing services (Lei, 2008:3).

In Europe, there has been the European Code of Best Practices Facilitating Access by SMME to Public Procurement Contracts. According to the European Commission (2008:2), this law addresses the need to develop a more SMME-friendly approach to public procurement. This SMME-friendly approach is aimed at creating awareness on the



relevant best practices in member states. The European Commission (2008) also argue that though the European Communities public procurement laws are there to ensure the opening up of markets for all economic operators without making a distinction between SMMEs and other economic operators of any type, there are however some provisions which mainly provide solutions to problems solely faced by SMMEs. These among others include SMMEs' access to public procurement.

While the situation on SMME access to public procurement contracts has not been different on the African continent, research has shown that enterprises in the sub-Saharan region continue to face some of the highest challenges (Rogerson, 2005). The business climate in most African countries continue to be plagued by a number of structural and institutional challenges ranging from limited finance, tax policies, and corruption (United States Agency International Development (USAID) (2005). However, in the midst of these challenges most governments are initiating policies and reforms to support the start-up and growth of SMEMs, which have the potential to support job creation and economic growth.

In Africa as in most parts of the world, the SMME sector has also been regarded as an important driver of the economic growth and prosperity of countries and regions. This has resulted in a number of support structures being put in place to ensure the rapid start-up, growth and expansion of SMMEs in the broader economic context of Africa. Some of these support structures have included, inter alia, easy start-up policies for new enterprises, tax holidays, and even initial start-up finance with minimum credit rates to stimulate entrepreneurship and sustain business growth in Sub-Saharan countries (Rogerson, 2005).

Dalberg (2011:4) carried out a research into the support granted to SMMEs in developing countries through financial intermediaries. This research reveals that support to SMMEs in developing countries through International Finance Institutions' (IFIs) interventions/ support systems such as technical assistance helps to build up the expertise and

knowledge of financial intermediaries particularly SMME lending. Dalberg (2011:4) further argues that this technical assistance goes a long way in helping catalyse a separate but sustainable SMME lending market. By so doing, IFIs play a vital role in catalysing the SMME market in these countries. South Africa and Mauritius have benefited from these schemes since 80% of the capital gains of the IFI's are reinvested back into these countries.

#### 2.2.3.2 SMME enabling environment in South Africa

Before getting to the support agencies, it is important to mention that SMMEs support in South Africa arguably only took place following the demise of the apartheid government. Diale (2009:196) observes that the apartheid system did significant damage to black business emancipation and the development of SMMEs in South Africa. The solution, therefore, laid in the new democratic government's re-ignition of the drive for SMME development. This drive marked a shift in the perception of SMMEs support towards a realisation of their central place as key actors in the economy.

It is arguably, only in the post-apartheid era that the South African economy began to place importance on SMMEs support and development (Rogerson, 2005). This support has especially been more practical than spontaneous in nature, with the aim of assisting different stages and sections in the development of SMMEs (DTI, 1995). Acknowledging the importance of SMMEs, many countries and governments strive to create a favourable environment for the birth and growth of SMMEs hence making the development of policies to advance a viable SMME environment their top priority (Dzansi, 2006:43). In South Africa, the National Small Business Act 102 of 1996 and the Government White Paper on National Strategy for the Development and Promotion of Small Business 1995 are the two main instruments used by the South African government to stimulate the growth of small businesses in the country. The national perspective on the SMME enabling environment in South Africa is summarised in the diagram below.

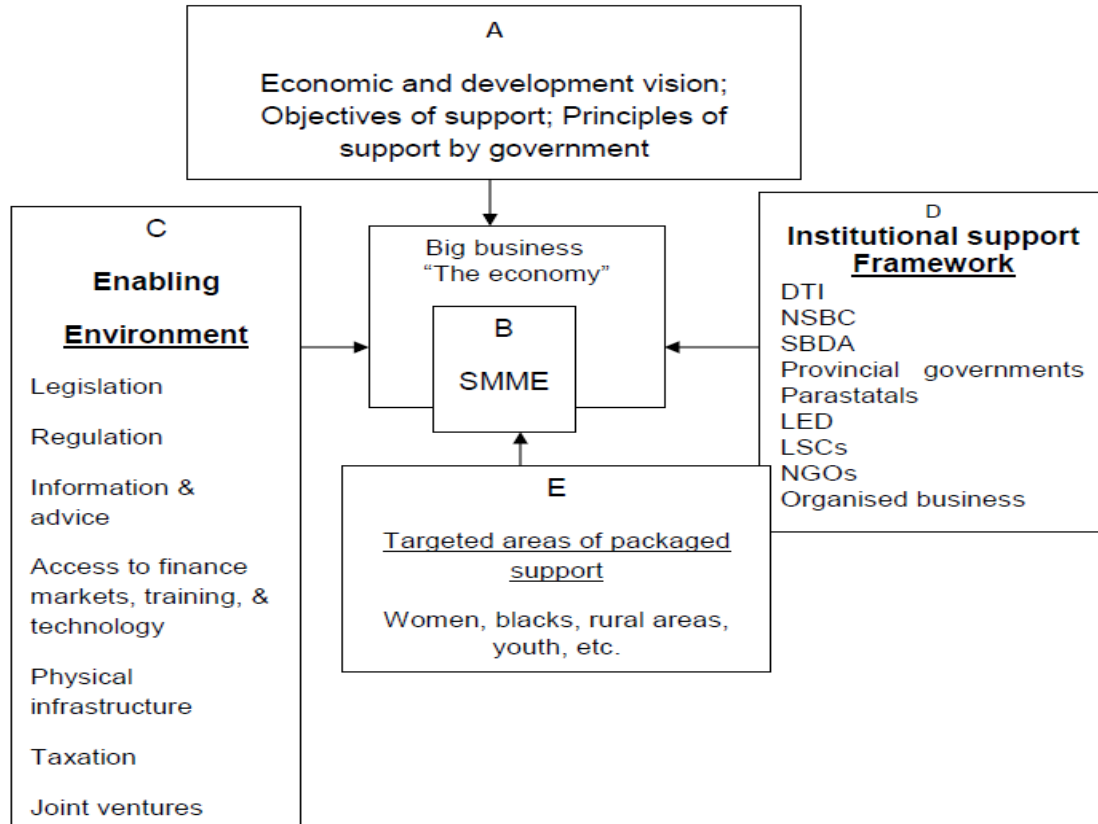


Figure 2.1: The national SMME support strategy

Source: White paper on National Strategy for the Development and Promotion of Small Business (1995:54)

The following section provides a discourse around the national and provincial SMME support agencies in South Africa.

#### 2.2.4 NATIONAL SUPPORT AGENCIES

The Department of Trade and Industry (DTI), which steers government policy through its facilitation of the growth of SMMEs has pioneered/spearheaded the establishment of two major business support agencies namely Khula Enterprise Finance and Ntsika Enterprise Promotion Agency (Berry et al., 2002; White Paper, 2005). Under the national SMME strategy, Ntsika Enterprise Promotion agency was set up to provide, promote and support

services to SMEs while Khula Enterprise Finance's aim was to assist SMEs financially through retail finance agencies. The subsequent sections provide a more detailed description of the national support agencies in particular their aims and objectives, market segmentation/clientele base, challenges and their strength and sustainability respectively.

#### 2.2.4.1 Ntsika Enterprise Promotion Agency

The Ntsika Enterprise Promotion Agency commonly known as Ntsika was initiated by the Department of Trade and Industry (DTI) in the post 1994 era to provide non-financial support to SMMEs. The target market of Ntsika is survivalist, micro and very small enterprises. A crucial component of this support structure was the establishment of a set of localised service centres, which afterwards became known as Local Business Service Centres (LBSCs). These centres assisted businesses with training services. The LBSCs focus on business start-ups targeting the unemployed, youth and women (Fongwa, 2011). These LBSCs were strongly associated with the development of SMMEs at both the regional and local levels and were conceived to be key role players in local economic development (LED) for local enterprises (Rogerson, 2004). Another major policy structure was the creation of the manufacturing advice centres (MACs). Boyd (2002) points out that MACs were aimed at assisting SMMEs in improving their competitiveness in local, national and international markets. The MAC program, launched in 1997, was conceived as a joint initiative of Ntsika, the DTI, the Council for Scientific and Industrial Research (CSIR), and the National Productivity Institute. Starting with two pilot programmes in Port Elizabeth and Durban, the MAC program had expanded its spatial coverage to 16 operational centres over the national territory by 2003 (NAMAC Trust, 2003). The Tender Advice Centres (TACs) were also put in place in the Ntsika Program to provide training and assistance on government tendering processes and make information related to tenders available to SMMEs. The centres and policy structures created by the Ntsika were however not successful because of the ineffectiveness of its communication strategies within the provinces. Most of the educational marketing materials of the Ntsika is in English and not in the local languages making the adaptation of these materials to the

realities of the rural SMMEs difficult (Mago and Toro, 2013:23). The challenges of the Ntsika led to its amalgamation with the Community Public Private Partnership Programme (CPPP) and the National Manufacturing Advice Centre (NAMAC), to form the Small Enterprise Development Agency (SEDA) (Rashaad et al., 2013:3).

#### 2.2.4.2 Khula Enterprise Finance

Established in 1996, Khula enterprise initiated a number of loan schemes to assist very small, small and medium enterprises SMMEs in accessing finance. The Khula Enterprise Finance (KEF), a national support initiative, was initiated to serve SMMEs in various capacities that were mainly geared towards providing financial assistance to enterprises. KEF operated a finance guarantee scheme, which brokered loan schemes between national banks and other private sector financial institutions that offer support for SMMEs. This was done mainly through sharing of some of risks of those enterprises that requested the loans. The retail financial intermediaries (RFIs) which have come into partnership with the KEF also provide support for SMMEs through risk-sharing, provision of business plans and supplying enterprises with advice on business start-ups finance applications (Fongwa, 2011).

It should however be noted that the RFI and Credit Guarantee schemes have witnessed significant failures as far as the survival of firms is concerned. These failures have been attributed to the relatively low level of awareness of the Khula initiatives when compared to some of the other initiatives like SEDA and hence less credit has been approved by banks for enterprises using individual credit guarantee schemes. This therefore, led to a number of initiatives by KEF geared at improving its services to SMMEs including:

- The establishment of monitoring programmes,
- Provision of the required technology by Khula to its partner firms to help them monitor loans more effectively,
- Reduction of all Khula supported RFIs to a manageable number and

- Development of capacity building programs for RFIs partners in areas of accountability, risk assessment, debt collection and administration.

The experience of the Khula Enterprise Finance is instructive. From the beginning, Khula's strategy was based on the assumption that there are enough linkages between the first (formal sector) and second (informal sector) economies. Khula also assumed that there were sufficient linkages between the first and second economies to generate demand for credit for micro enterprises that would act as suppliers to the first economy. As it turned out however, these linkages were not available in sufficient quantity. This assumption resulted in a dramatic reduction in the number of credit retailers through which Khula could extend capital (Stephen, 2011:28). Khula eventually opened 'micro-credit outlets' in order to cater for the smaller enterprise clientele which was not accessible through its intermediaries. The effect of this was that, KEF was in reality trying to encourage credit uptake among a category of entrepreneurs for whom credit is often not the most immediate need (Aliber et al., 2006). Eventually, Khula enterprise together with the South African Micro Apex Fund and the small business activities of the Industrial Development Corporation (IDC) merged to form the Small Enterprise Finance Agency (SEFA). SEFA opened its doors on April 1st 2012 (SEFA, 2012).

#### 2.2.4.3 The Department of Trade and Industry (DTI)

The DTI which targeted all registered small businesses, in partnership with the National Small Business Corporation, Small Business Development Agency and Regional Development Corporation initiated a number of incentive schemes aimed at supporting registered SMMEs in the country (DTI, 2004) and these include:

- Standard leased factory scheme;
- Small/medium manufacturing development programme;
- Economic empowerment scheme;
- Venture capital scheme;
- Normal finance scheme;

- Import finance scheme;
- Short-term export finance guarantee scheme; and
- Export marketing and investment assistance scheme (DTI 2004).

The implementation of these incentive schemes by the government was guaranteed through the creation of two main bodies at regional (provincial) and national levels. These bodies are the Centre for Small Business Promotion (CSBP) and the government's Reconstruction and Development Plan (RDP) respectively. The CSBP was aimed at coordinating and monitoring the performance indicators of the government's national strategies while the RDP supported SMMEs through employment creation, income distribution and growth (DTI, 2004).

The government's RDP also laid major emphasis on entrepreneurial awareness and training, which actually took off in the early 1990s with vocational colleges recognising the need for intensive training and certification in intensive entrepreneurship training (Ladzani and van Vuuren, 2002). The CSBP's mandate included the creation of the Provincial SMMEs desk aimed at linking the national support agencies with regional/provincial support agencies (Chalera, 2007).

In the mid-2000s, the small business climate saw another policy initiative with the establishment of the Integrated Small Business Strategy (ISBS). The vision of the ISBS is to make South Africa "an entrepreneurial nation" with a more broadened clientele including previously disadvantaged individuals (DTI, 2006). However, a challenge of the DTI is that it only offers support which is mainly non-financial to small businesses under the umbrella of the Government (registered small businesses) as opposed to small businesses in the informal sector (unregistered).

The Department of Trade and Industry (DTI) is actively involved in promoting trade and investment as well as expanding the business of SMMEs across the country. According to the Black Economic Empowerment (BEE) act 53 of 2003, the department is tasked

with “increasing broad-based and effective participation of black people in the economy and promoting a high growth rate, increasing employment and more equitable income distribution” (DTI, 2005).

#### 2.2.4.4 The National Youth Development Agency

The National Youth Development Agency Micro loans are financial loans given by the Enterprise Finance Division of the National Youth Development Agency (NYDA). Established in 2008, the services of the NYDA are offered to youths between the ages of 18 to 35 years and also to emerging enterprises or enterprises owned by women. The NYDA’s annual report (2011-2012:22) suggests that to this end, 12 579 jobs have been created by the NYDA and R32 million was issued as loans to young entrepreneurs. The company also assisted young entrepreneurs to access R36.8 million in funding opportunities. These funds enabled these young entrepreneurs to sustain and grow their business thereby improving the livelihood of these youths. However, the NYDA was not successful in achieving its aim of reducing the challenges faced by the youths and women in South Africa such as joblessness, inequality and poverty as it suffers from misappropriation of funds and corruption which led to the arrest of its head (ANC Youth League, 2013).

#### 2.2.4.5 The Small Enterprise Development Agency (SEDA)

Small Enterprise Development Agency (SEDA) was established in December 2004, through the National Small Business Amendment Act, Act 29 of 2004 (RSA, 2004). The main focus of the company is on developing services and products for small, micro and medium enterprises, while continuing to provide the existing services and products to medium enterprises. Unlike many supporting agencies in the Free State, SEDA’s target market is clearly defined and approximately 20% of the company’s focus is on Medium enterprises whilst the Small, Micro (formal, informal) and co-operative enterprises get 80% of the Agency’s focus.



SEDA has the mandate to implement national governments small business strategy, design and implement a standard and common national delivery network that must be uniformly applied throughout the South Africa with respect to small agencies across all tiers of Government. The agency is a culmination of the merger of the following: Ntsika Enterprise Promotion Agency; National Manufacturing Advisory Centres (NAMAC), Community Public Private Partnership Programme (CPPP), SEDA Technology Programme (STP) and the SMME support activities of the South African Quality Institute.

The agency is widely spread across the country and has 40 branches and nine (9) provincial offices in the Eastern Cape, Free State, Gauteng, KwaZulu Natal, Limpopo, Mpumalanga, Northern Cape, North West and Western Cape; 46 Enterprise Information Centres; and 29 technology incubators spread across the country. The numerous branches of SEDA provide different forms of support aimed at assisting businesses in the various phases of their business growth life cycle and they include the following (offerings) plus their provided assistance. The table below provides a summary of the various branches and forms of support provided by the SEDA.

Table 2.4: Summary of support provided by SEDA branches

<b>Offerings</b>	<b>Purpose</b>	<b>Assistance</b>
SEDA Business Talk	Offering information on starting a business to clients	Business advice and Information Business registration Small Enterprise Training
SEDA Business Start	Provides tools and techniques to clients who are ready to start up a business	Business Planning Business Counselling Access to finance Business Support
SEDA Business Build	Offering Skills to clients to sustain and strengthen their business.	Capacity Building Systems Mentorship Tender Advice /Procurement Export Readiness and Franchising
SEDA Business Grow	Infrastructure for growth	Business Systems Development Cooperative Support and Growth Strategies

Source: SEDA Profile (2011).

Support courses provided by the company for entrepreneurial success include SEDA's five-day entrepreneurial training course to empower small business owners with the necessary skills to enable them to take their businesses to greater heights. During the training courses, entrepreneurs are expected to learn to market their businesses effectively and understand the importance of building a reputable business profile. The training courses also cover financial management, customer care, report writing and business writing skills. These skills help entrepreneurs to identify areas for improvement of their businesses. The core services delivered at the branch level include business planning, small enterprise training and mentoring, access to markets, facilitation of access to finance, business registrations and support for co-operatives and access to technology (SEDA Profile, 2011). Despite the numerous services provided by the SEDA as discussed above, SEDA's weakness is that it does not operate in rural areas but only in Metropolitan areas, limiting access to SMMEs in the rural areas who are hardly even aware of their (SEDA's) existence and operation.

#### 2.2.4.6 The Basic Entrepreneur Skill Development Programme

The BESD neither provides financial or non-financial assistance to SMMEs but rather coaches them (SMMEs). The BESD was implemented by the Department of Labour to create skills in the informal sector. Essentially, the programme is demand-driven in that business coaches or trainers otherwise known as Entrepreneurial Development Practitioners (EDPs) coach entrepreneurs at their places of business (Mathibe 2010:50). The target market of the BESD is SMMEs still in the informal sector or the second economy but willing to become registered or formal.

A study conducted by Marais and Lenka (2007) suggests that the BESD programme seems to have had a positive impact on the businesses which have been coached. This impact has been manifested in higher profits, improved marketing, more client satisfaction, a more nuanced understanding of business processes and a more equally distributed gender business profile in South Africa (Mathibe, 2010).

One of the biggest challenges faced by the BESD in coaching SMMEs is its (BESD) failure to keep records of businesses still in the informal sector. This lack of documentation complicates a clear understanding of the number of informal businesses willing to become formal and the number of informal businesses actually becoming formal.

## 2.2.5 PROVINCIAL SUPPORT FOR SMALL BUSINESSES IN THE FREE STATE

After examining the supporting agencies at the national level, the provincial level situation which is the focus of this study, is also examined in this section. Unravelling the policy structures of the Free State province, a number of the national policies were translated to the provincial and regional as well as local levels as provided below. Other organisations and offices such as the Premier's Office provided various policy platforms for emerging SMMEs.

### 2.2.5.1 The Free State Premier's Project

The Free State province guided by the Premier's office in partnership with SEDA and the Flemish government have provided a major support structure to SMMEs in the province. The programme is aimed at providing support to schools offering entrepreneurship courses. In this support strategy, much attention is paid to the skills development of the learners. This support was motivated from the Free State Growth and Development Strategy (FSGDS), which clearly established job creation and economic growth strategy for the province (Fongwa, 2011) as critical in achieving sustained economic development. The programme focused on four geographical areas in the province, namely, Matjhabeng, Thaba-N'chu (Mangaung), Tokologo, and QwaQwa (Maluti-a-Phofung). The overall idea of the programme was to ensure that these four geographical areas focus on an intensive business support scheme with the following specific objectives.

- Providing extensive and continuous training and monitoring for emerging SMMEs,
- Facilitating and improving market access for individuals and SMMEs,
- Facilitating placement and mediation between SMMEs, private and public sectors,
- Promoting innovative employment and job creation by SMMEs and

- Establishing effective social service outreach programmes for patients affected or infected with HIV/AIDS.

The Free State Premier's Project offers free training and services at no cost to SMMEs in the province. This support service had many results in the province such as the coordinated provision of training to entrepreneurs, especially the organisations, unemployed individuals and training of individuals in the informal economy.

Despite the promising nature of the partnership aimed at assisting SMMEs in the province, Mathibe (2010) argues that the programme suffered from logistic and administrative red-tape within government hence hampering the envisaged positive impact of the structure.

#### 2.2.5.2 The Free State Development Corporation (FDC)

The Free State Development Corporation (FDC) was established in 1995 with a mandate to advance economic development in the province. The FDC has as its target market every company involved in the different sectors of the economy with the exception of public transport and primary farming, which according to the company is a very risky investment which they will rather avoid. Although the FDC prefers businesses registered with SARS to businesses that are still in the informal sector (unregistered), it however remains open to all businesses as long as they:

- Are in possession of a detailed business plan;
- Have clear and concise cash flow projections; and
- Business owners have appropriate experience to run a business.

The FDC's role in SMME support and development came into existence after the amendment of the FDC Act 9 of 1999, and Act 4 of 2006. In this amendment, the Act sought to promote the urban and rural SMMEs in the province by giving loans to qualifying entrepreneurs for start-up capital, expansion capital, bridging finance and non-financial

business support (FDC Annual Report, 2005/2006; 2007/2008). These aims were laid down in a provincial Strategic Plan (2007-2010) in which the different avenues through which support would be channelled to the SMMEs would include:

- Training and non-financial support;
- Creating market access for SMMEs; and
- Financial provision to SMMEs.

According to the National Directory of Small Business Support Programmes (2010), the FDC financial provisions to SMMEs have been sub-divided into seven products which are: micro-loans, co-operative funds, bridging loans, financial initiators, step-up loans, propeller finance and equity loans. The company also offers after care services to business to serve as a close follow up on the registered companies. The FDC in their after-care assistance, work step by step with clients till they believe they can survive on their own. It should, however, be noted that depending on the client involved, FDC often refers clients to SEDA for assistance in designing their business plan. The FDC also refers some of its clients to the Central University of Technology (CUT) which is equipped with a *phab lab*, a programme which offers manufacturing advice to clients.

Another important aspect of the relationship of the FDC with their clients obtained from Mabote (2011) an employee of the FDC in Bloemfontein is that they also offer the possibility of investing in the client's company. The company does that by providing financial support that is most needed by many especially since it gives them the assurance that they are on the right track and have a back-up. This kind of assistance, however, depends on company's budget allocation of the year which usually ranges from 10 million rands upwards. If a company which must also be a client of the FDC is in need of a loan which is far less than the budget, it is easier for the FDC after testing the viability of such a company to make a positive financial move. Nevertheless, if the client demands more money than the FDC can offer, the FDC, after calculating the company's security measures, gives percentage assistance to the client and then lends some money to the client based on their cash flow projections. By lending money to the client, the FDC goes

into a joint venture with the client which can even be in the form of a 50/50 stake (Mabote, 2011). In the case of a joint venture in which case the FDC officially does business with its client based on the money it lends to the client in question, the client is given the opportunity to bail itself if it makes money and is able to pay back what it owes the FDC.

The FDC however faces the challenge of dealing with its after-care services to the registered companies and also in dealing with the insolvency of some clients resulting in the closing up of the clients' business operations. This state of insolvency sometimes also result in the seizing of the client's business properties until the client is able to pay back its loan (Mabote, 2011).

From the discussion of support structures at the national and provincial levels, it can be argued that the government makes much effort to exclusively support businesses in the formal sector (registered businesses). There is little or no awareness of these support structures by businesses still in the informal sector willing to become formal.

## 2.2.6 SUMMATIVE ASSESSMENT OF SMME ISSUES

The previous sections sought to provide an overview of the importance of SMMEs and how SMMEs are being supported with a focus on national policies in South Africa and provincial policies in the Free State province. The review reaffirmed the importance of SMMEs in economic growth mainly through job creation and contribution to GDP. However, the conceptualisation and definition of SMMEs globally and in South Africa remains context and even sector-specific due to the paucity of a universal definition.

Another key finding from the literature review is that SMMEs are benefiting from a number of policies and structures aimed at enhancing their start-up and growth. While SMMEs continue to face numerous challenges, there is evidence especially in South Africa of increased efforts from public agencies to support SMMEs nationally. Nevertheless, the review reveals that these initiatives for providing the enabling environment and incentives for SMMEs start-up and growth are also confronted with multiple challenges.

A further discussion of these challenges will be presented in the next section which presents the informal sector in South Africa. This is done in an attempt to capture some main factors which influence entrepreneur's decisions to either remain informal, or going formal. The section also highlights some challenges faced by firms in their transition process from the informal sector to the formal sector and the importance of the informal sector in South Africa at both national and provincial levels.

## **2.3 PERSPECTIVE ON THE INFORMAL BUSINESS SECTOR**

The previous section examined the general SMME environment in South Africa. This section examines the informal sector in South Africa with a view to unravel the formalisation process of informal businesses.

### **2.3.1 DEFINING THE INFORMAL SECTOR**

The complexity of the term *informal sector* is derived from its numerous definitions. In this study, an attempt towards a historical and contemporary definition of the informal sector is provided with the aim to enhance the shifting understanding on the concept.

#### **2.3.1.1 Historical definition of the informal business sector**

The social anthropologist, Keith Hart, first coined the term informal sector in the 1970s. Hart (1973) used the term in the developing world context to describe a part of the urban labour force, which works outside the formal labour market. For Hart (1973:69), the informal sector is a traditional urban economy with a low level of productivity and informal income opportunities whether in primary, secondary or tertiary economic activities. Hart (1973) considered the informal sector as almost synonymous with all categories of (small) self-employed individuals. Thereafter, the term was adopted to refer to ways of making a living outside the formal wage economy, either as an alternative to it or as a means of supplementing income earned within it (moonlighting).

Informality here is mainly characterised by the avoidance of government regulations and taxes. Though the early work on the informal sector can generally be attributed to Hart, ground-breaking research into the informal sector is generally considered to be a report of the International Labour Office (ILO, 1972) on employment in Kenya.

In South Africa initially, the relationship between the formal and informal sectors was merely seen in terms of the traditional-modern dichotomy that existed for many years in the economies of developing countries. The westernized modern sector was regarded as the source of dynamism and change in those countries and it was the perception that this sector was most likely to keep on growing while the traditional (informal) sector would slowly wither away ( Geyer et al., 2011).

High rates of unemployment were mostly faced by the African population of South Africa which is made up of the black, coloured and Indians (the apartheid generated identity signifiers which continue to be used in post-apartheid in South Africa although their meanings are heavily contested). This African population was the underprivileged during the apartheid regime given their poor skills and low education attainment. The lack of skills and education, lack of job opportunities resulted in many of them resorting to the informal sector as a means of subsistence and source of living. Though there was a change in constitution which took effect in 1994 and laid emphasis on freedom and equality amongst all genders and races, it did not stop the existence of the informal sector. This is so because the South African formal economy remains a largely untransformed economy if racial demographics are considered notwithstanding a growing number of black middle class. More so, there is significant level of “Black owned” businesses in the formal sector in the wake of “fronting” which obstructs a proper reality check on strides of transformation in the corporate sector. This is in light of South Africa’s policy of Black Economic Empowerment (BEE) of 2003 which aims at narrowing the gap between the South African racial demographics by helping to bring the black majority into the economic mainstream (DTI, 2013).



### 2.3.2 THEORIES ON FIRM TRANSITION TO THE FORMAL SECTOR

The transition of firms from the informal business sector to the formal sector is largely informed by the different schools of thought on the informal business sector (Devey, Skinner and Valodia, 2006:5). Devey et al. (2006:5) argue that there are three main theoretical views regarding the way the informal business sector relates with the formal sector, namely; the Dualist, the structuralist and the legalist schools of thoughts. These schools are discussed in their respective order below.

Firstly, the Dualist School promoted by the early work of the International Labour Organisation (ILO) in the 1970s conceives the informal sector as a set of separate marginal activities not linked directly to formal sector. The Dualist School views the informal sector as one that provides salary or safety net to the poor who are not competent to access employment in the formal sector. This school of thought (Dualist) regards the persistence of informal activities to be a consequence of a lack of job opportunities to absorb surplus labour due to a faster rate of economic growth (Menya, 2009: 10). The position of the dualist school, which argues that the informal sector optimises the national economy by creating jobs thus providing opportunities to the unemployed, contradicts this research. Supporting this line of thinking, the researcher identifies with Neves (2010:2) who argues that the informal sector supports socio-economic growth (unemployment).

Another school of thought – *structuralism*, promoted by Castells and Portes (1989) amongst many others in the 1970s and 80s views the informal sector as subordinate to the formal sector. Devey et al. (2006: 5) view the informal sector as “a set of subordinated economic units who serve to reduce the input and labour costs of the large, formal enterprises). Growth in profitability in the formal sector is in part dependent on growth in the informal sector (Devey et al., 2006:5). Janneke, Ana and Abdul (2011:3) argue that there is a positive relationship between employment in the formal and informal sectors but only in the most modern informal sector activities. The modern informal activity mentioned by Janneke et al. is the “entrepreneurial” side of the informal sector

characterised by more hired workers per firm, more dynamic technology and substantial incomes.

While the above thoughts on the Structuralist school have proven to be true in the case of India as most of the studies were conducted in that country, these may not necessarily apply to South Africa because of contextual reasons such as the national support systems available in the different countries per sector. The argument of Janneke et al. (2011) seems to be based on the assumption that two segments exist in the informal sector, which are the modern informal sector and the traditional informal sector. Traditional informal sector here refers to a “survivalist” free entry sector with little capital as opposed to South Africa where the subject is simply addressed as the informal sector without any segmentation.

Lastly, the Legalist School popularised by De Soto (1989), views the informal sector as comprising entrepreneurs who choose to carry on their activities in the shadow economy in order to avoid the challenges of formalisation such as cost of registration and long queues involved in the process of registration (Devey et al., 2006:5). This view is in line with the central argument of this study and will be discussed in detail below in an attempt to understand the challenges faced by firms in their transition process to the formal sector.

### 2.3.3 ARGUMENTS FOR TRANSITING TO THE FORMAL SECTOR

From the perspective of policy makers and government at large, there is need for businesses in the informal sector to move to the formal sector because, though they inject money into the economy and form part of the circular flow of income, informal businesses in many ways cause distortions in measuring national socio-economic accounts (GNP) (Gërxhani, 2004: 275).

From the perspectives of owners/managers of informal businesses, although tax avoidance may provide an incentive to remain informal, there are equally compelling reasons why informal businesses will want to formalise their operations. Omar (2006:9)

points out that there are some benefits such as; access to credit, access to a larger market, possibility to limit liability and risk, ability to document contracts and relationships that accrue to businesses as a result of formalization. Another reason to formalise informal business is the desire to grow. The formalisation of the informal sector may lead to business growth through the expansion of business networks. Furthermore, little capital is invested by the owners of informal businesses, and income generated falls below a minimum income standard as the owners usually live on any surplus revenue. Opportunities for expansion into a viable business are therefore severely limited though not impossible (Rolfe, Woodward, Ligthelm and Guimarães, 2010:7).

However, the formalisation of businesses in many developing countries including South Africa is a difficult process mainly due to a number of inherent challenges in the formalisation process as well as the specific business environment (Abeysekera, 2005:11). Some of these challenges are discussed below.

#### 2.3.4 IMPORTANCE OF THE INFORMAL SECTOR

The importance of the informal sector has been discussed at the global (Gërkhani 2004:5, USAID, 2005:4) and national level (Janneke et al., 2011:2; Von Broemsen, 2007:11). At both levels, as well as local level, the contribution of the IBS sector can either be to the respective individuals or to the national or regional economy, which is aptly captured in the GDP. These include the contribution to the creation of jobs, tax returns to the government, providing a sense of social upliftment and accomplishments and enhancing skills development for young entrepreneurs. This section focuses on the importance of the IBS more at a national and regional level. At the national level, three issues of importance are discussed. These are the provision of jobs, providing a safety net for those without skills and not able to go back to school or contribution to the Gross Domestic Product (GDP) of the nation.

The importance of the informal sector in South Africa will be mainly discussed under four headings namely; Employment creation, Economic growth support, Labour creation and Tax avoidance.

#### 2.3.4.1 Employment creation

Since the first democratic elections in 1994, South Africa has undergone remarkable social, economic and political changes to improve on the lives of thousands and millions who do not have access to basic economic and social services. One of such changes has been the introduction of policies to enhance the maximum participation of all races in the economy; hence increasing racial diversity within the workforce (Neves, 2010:5). However, with the increasing population growth, compounded by high numbers of skilled and unskilled immigrants from the Southern part of the continent and beyond, job creation in formal economy has remained a major challenge. As a result, self-employment is fast becoming an escape route for the unemployed who are bent on achieving their economic goals as well as those who may be formally employed but are willing to resign to implement their own business ideas.

In the new democratic dispensation, the informal sector has been a major source of employment for the black African population.

According to Van Rooyen (2007:335) the informal sector contributes one-half to three-quarters of non-agricultural employment in developing countries with 72% pertaining to sub-Saharan Africa with the exclusion of South Africa. With the above figures, it can arguably be said that South Africa on its own contributes about 28% of informal employment in the agricultural sector which is quite a huge contribution to job creation in the economy. A comparative study conducted by the bureau of Market Research from 1980 to 2005 conveyed that the number of businesses in the informal sector which was 6% in 1980 increased to 7.7% in 2004/2005 while there was a decrease in the number of businesses in the formal sector from 45.7 % in 1980 to 27.7 % in 2004/2005. Another study by the International Labour Organisation and the World Trade Organisation (ILO

and WTO 2009) reveals that the informal sector contributes about 50% to 80% of employment in developing countries. A more recent study carried out by Statistics South Africa (STATSA) from April 2010 to June 2011 suggests that the informal sector of South Africa increased from 13061 to 13125 accounting for about 0.5 percent increase per year. The above statistics indicate a progressive increase in the employment creation of the informal sector.

#### 2.3.4.2 Economic growth

Von Broemsen (2007:11) asserts that in South Africa, there are between 1 and 2.3 million informal businesses, contributing between 7 and 12 percent to South Africa's Gross Domestic Product (GDP). Micro-level studies - seven in total - suggest that between 3 and 7 out of every ten household involved in informal settlements take part in some kind of informal income generating activity in South Africa. In line with the above, a recent view suggests that the informal sector accounts for 20 to 55% of non-agricultural GDP in developing countries (ILO and WTO, 2009). According to Perry et al. (2007:22), Micro enterprises with no intention to enter the formal economy motivated by their lack of willingness to pay income taxes will prefer to stay in the informal sector. There is however an element of tax returns, considering that even for businesses that do not pay direct taxes, they pay indirect taxes through their bulk paying of goods and services from their suppliers.

In light with the contribution of the informal sector to economic growth, Tshuma and Jari (2013:252) suggest that the argument for the sector's contribution towards GDP emanates from the fact that this sector apart from growing at a rapid rate also gives the illiterate and even the unskilled a chance to earn an income; hence supporting socio-economic development at local level. Tshuma and Jari further argue that this contribution to GDP by the informal sector has made this sector to be one of the leading sectors in many national economies with South Africa as an example (7-12%).

#### 2.3.4.3 Social development

The informal sector has played a great role in the social development/upliftment of the living conditions of many in South Africa especially the under-privileged. It is estimated that those employed in the informal sector earn on average between R 1200 to R 1600 a month (STATSA, 2010:15). According to Statistic South Africa (STATSA, 2008:3) poverty alleviation and the riddance of inequalities created during the apartheid era lie at the hub of development policy in the South Africa post–apartheid era. The desire to uplift the population of South Africa led to the following address by the then president.

*'Endemic and widespread poverty continues to disfigure the face of our country. It will always be impossible for us to say that we have fully restored the dignity of all our people as long as this situation persists. For this reason the struggle to eradicate poverty has been and will continue to be a cornerstone of the national effort to build the new South Africa' (Mbeki, 2004).*

It can be argued that one of the biggest challenges of poverty is unemployment. The creation of jobs by the informal sector has significantly helped to alleviate poverty and also to take away people from crime and drugs as they engage in small economic activities (Tshuma and Jari, 2013:252).

The above section has endeavoured to provide a brief overview of the importance of the informal sector at global and national level. While there has been studies to monitor the importance of the informal business, such efforts have also been hampered due to a lack of data on the informal business. The next section provides a brief discussion of some of the approaches used to measure the informal business.

#### 2.3.5 MEASURING THE INFORMAL SECTOR

A convenient point to begin with is to understand why it is of significance to measure the informal sector. Jamie, Talmage and Yusef (2006:16) argue that the contribution of the

informal sector to local and global economies is enough reason to compel profit and non-profit making organizations to collaboratively determine a comprehensive method of measurement of this sector. Jamie et al. (2006:16) point out that an accurate measure of the informal sector is important because it can aid governments in the identification of uncollected tax revenue leading to a more exact estimate of a country's GDP. Apart from benefiting governments, the measurement of the informal sector could also be of importance to urban community development. In line with the above point, better information on small informal businesses might encourage the engagement of a mainstream of small business lenders (Jamie et al., 2006:16).

Garcia- Bolivar (2006:7) argues that measuring the size of the informal sector is a difficult and problematic exercise. Garcia-Bolivar's (2006:7) argument on measuring the size of the informal sector is strengthened by the fact that there is no identification system (documentation) that keeps records of the informal sector. Also that informal sector often comprises unregistered businesses. It can arguably be said from the above that an identification criterion is critical to determining the real size of the informal sector which is necessary to correct the distortions (by providing a real value for the size of the IS during calculation) made to the country's Gross National Product (GNP). Registration on its own enables the contribution of the informal sector to the GDP of a country to be determined easily.

Madziakapita (2003:51) outlined two different ways of measuring the size of the informal sector as: (i) estimation of the number of people employed in the informal sector. This is the easiest way of measuring the size of the informal sector; and (ii) estimation of the value of goods and services (profits) produced by the informal sector. This later method is more interesting when calculating national income accounts but is more difficult because of the sector's lack of sales records and documentation of profit margins (Madziakapita, 2003:51).

Husmanns (2004:11), unlike Madziakapita (2003:51) suggests that Labour force surveys (LFS) should be used as a source of data for measuring the size of the informal sector. Husmanns argues that the number, characteristics of persons working in the informal sector and their working conditions can be attained by including in an existing LFS periodically a few questions affecting the informal sector and its characteristics. These questions must be asked of all the people employed in the sector during the reference period of the survey and should be asked irrespective of their status in employment. When this method is applied, Husmanns (ibid) argues that it would be possible to collect ample information on the characteristics and volume and employment from all categories of the informal sector.

### 2.3.6 CHALLENGES FACED BY FIRMS IN THEIR TRANSITION PROCESS

The formalisation of informal businesses comes with many inherent challenges; some of which will be discussed in the subsequent sections. Some of the identified challenges include: the lack of adequate information, regulatory barriers, administrative barriers, the fear of the unknown and the business being too small to reap the benefits of formalisation.

#### 2.3.6.1 Lack of information and limited skills

The lack of proper information on government support agencies put in place to assist small enterprises in the informal sector to become formal is a great impediment to formalisation. Lack of information on the process of formalisation is corroborated by Mahembe (2011:42) who argues that a variety of independent studies propose that very few firms in the informal sector are aware of government support initiatives to support small enterprises. This lack of information on the process of formalisation accounts for the large number of firms/businesses still remaining in the informal sector. Another challenge faced by businesses in the informal sector willing to move to the formal sector is their lack of education, business skills and training, coupled with the lack of support from the government (Ntema and Marais, 2012:3).



### 2.3.6.2 Regulatory barriers

It is also argued that the complex and costly procedures involved in the transition process prevents many firms from becoming formal. As revealed by McCulloch, Schulze and Voss (2010), the process of formalisation is considered by many businesses as time-consuming and costly (reasons why many firms prefer to keep their businesses in the informal sector rather than moving formal). Many studies including the United States Agency for International Development (USAID 2005); OECD (2006); Mc Culloch et al. (2011); and Mahembe (2011) have identified costly and burdensome government regulation as the most significant challenge to formalisation. Another aspect of cost which needs to be highlighted here is the cost involved in starting up a business.

### 2.3.6.3 Administrative barriers

Another challenge faced by firms in their transition process from the informal sector to the formal is the administrative barriers. These administrative barriers include: long queues endured during the process of formalisation, the excessive paper work involved, the lengthy process of formalisation which might take up to three weeks in Bloemfontein, the inaccessibility of services for feedback or progress on the evolution of the registration. These administrative barriers according to OECD (2006:29) have so many sources amongst which out-dated ways of working, over-complicated regulations and corruption are implicated.

### 2.3.6.4 Financial requirements and business fees

The challenge of financial requirements and business fees are caused by poor administration, overly complex tax regulations and regressive fees which penalize small firms. The minimum capital requirement (fees) to start-up a registered business is usually set at a level too high to be afforded by firms in the informal sector. Firms or businesses in the informal sector are motivated by the desire to avoid taxes mostly because most of them do not understand the tax regimes. Their lack of knowledge on how to comply with

the tax requirements makes them not to believe that they will get any services in return for paying taxes (Maliyamkono et al., 2012:367-368) hence acting as a challenge to formalisation.

#### 2.3.6.5 Corruption

Corruption is a major challenge faced by firms/businesses in their transition to the formal sector as businesses stay off tax rolls and registries because they do not trust the government but view the payment of bribes as a sort of tax to get things done. Corruption corrodes the trust that firms/businesses have in the government and leads informal businesses to come to the conclusion that their long-term forecasts in the formal sector/economy are poor. Therefore, an attempt to reduce the challenges faced by firms, businesses in their transition process will be futile if corruption is not also tackled (Ingram et al., 2007:29).

#### 2.3.6.6 Fear of the unknown

The uncertainty around the survival of the business beyond its infancy stage also explains the unwillingness of some firms to become formal. This is so because there is no clear guarantee on whether the business will survive the infancy stage. This infancy stage is the stage where many businesses die due to the strong competition faced from the already existing businesses, which most of the time use their already established familiarity to reap the benefits of the infant business.

#### 2.3.6.7 Smallness

The small size of some businesses is considered a great challenge in formalising informal businesses. McKenzie and Woodruff (2006) argue that costs of registering do not always establish a significant barrier to maximising the benefits of formalisation as the size of many firms does. As such, the thought of businesses being too small to reap the benefits of formalisation further compound the challenge of resisting formalisation.

## 2.3.7 SUPPORT STRUCTURES FOR TRANSITION

The support structures can be perceived from national and international levels. The first part of this section provides a discourse on the informal sector support internationally and the second part presents the informal sector support in South Africa.

### 2.3.7.1 Informal sector support – international perspective

Enterprises in the informal sector have received support through policies designed by some governments with the aim of encouraging them to invest in skills. This is done by subsidizing the investment cost through various measures. The incentives may however vary with respect to their impact on the actual amount of training being done. Three of the main incentives structures include training funds, the use of voucher programmes and the introduction of payrolls training.

#### ***Training funds***

Twenty-one countries in Sub-Saharan Africa have introduced training funds financed by payroll taxes such as the ones Namibia recently proposed (Avril et al., 2013:33). These training funds serve to compensate enterprises for the cost of qualified training undertaken. Governments also subsidize training cost by letting enterprises deduct eligible training costs from their income intended for tax purposes (Adams, 2008). In a review of international experience with training funds Dar, Canagarajah and Murphy (2003) found that small employers do not substantially benefit from these schemes. They argue that the financial incentives offered do not sufficiently offset the other factors earlier mentioned that dissuade training by small enterprises. As a result, training funds with levy-grants schemes tend to be favourable to larger enterprises and the training of more highly educated and skilled workers in these enterprises. Dar *et al.*, 2003 also found that there are, nevertheless, exceptions as found in the case of Singapore and Malaysia because both countries acknowledged the low involvement of small enterprises in their levy-grant funds. Amongst the solutions offered were subsidies to conduct training needs assessments, pre-approved training courses which do not require costly application nor

justification and the use of the additional training capacity of large enterprises by smaller firms.

### ***The use of voucher programmes***

Vouchers are offered to workers in the informal sector and craftsmen to help workers pay for their selected training. Voucher programmes to encourage training in the informal sector were used in Kenya, Ghana and Singapore and are discussed below.

The Jua Kali Voucher programme has been introduced in Kenya to encourage training in the informal sector (Johanson and Adams 2004). This program was successful in lowering cost and expanding the supply of training to workers in the informal sector in its initial stages. There was evidence of its positive impact on the salaries of participants and improvement in the capacity of local Jua Kali Associations responsible for distribution of the vouchers. Problems of corruption were however encountered later leading to high administration costs. A similar voucher programme that targeted the informal sector enterprises was offered in Ghana in the early 1990s that largely failed due to lack of attention to the design of the marketing and distribution of the vouchers (Johanson and Adams, 2004).

Singapore offered training vouchers to enterprises with less than 50 employees that could be used to settle up front training costs to ease cash flow problems. The vouchers helped Singapore's Skills Development Fund reach 65 percent of enterprises with 10 to 49 workers and 14 percent of those with fewer than 10 workers (Adams, 2008).

### ***Introduction of payrolls training***

The introduction of training levies on payrolls is globally used to mobilize additional resources for skills development (Arvil et al., 2013). Adams (2008:16) argues that, the impartiality of the levy is based on the taxation principle that, the beneficiaries from the resources spent on training should be the ones to pay (the levy). Adams (ibid) elaborates

that payroll levies have been used to finance training by national training organisations in Latin American countries such as Brazil, Columbia and Venezuela.

Countries allow registered enterprises to deduct the cost of training from their income as before taxes. However, in the case of the informal sector where small enterprises may not earn enough income to pay taxes, or may simply avoid paying taxes, these deductions may serve as a limited incentive for training. Adams (2008:18) points out that the same result may apply to tax credits that are targeted to selected enterprises in return for agreed training and employment actions. Where the credit can be refunded to the enterprise in the absence of a tax liability, this may serve as an added incentive for training and even registration of the enterprise, but once again may not be sufficient to prompt small enterprises in the informal sector to train.

#### 2.3.7.2 Informal sector support in South Africa

Since informal businesses are generally micro in nature, they do not receive independent national support in South Africa but rather, support is geared towards registered SMMEs. The support structures offered to SMMEs at the national level were already discussed above as national support agencies.

#### 2.3.7.3 Informal sector support in the Free- State province

According to Nel (2005:2), the South African government argues that “the central responsibility of municipalities is to work together with local communities to find sustainable ways to meet their needs and improve the quality of their lives”. Below is a brief summary of Mangaung support initiatives for the informal sector which is the focus of this study.

Mangaung is a municipality situated in the city centre of Bloemfontein in Free State province in South Africa. According to the African Institute for Community-Driven Development (2005:14), Mangaung stretches to include Botshabelo and Thaba-N’chu

which are two major centres of apartheid's 'displaced urbanisation'. The informal sector of Mangaung according to Nel (2005:15) accounts for 50% of local jobs in the area, which is the focus of the current case study. From the point of view of the Mangaung municipality, as mentioned by the African Institute for Community-Driven Development (2005:13), informal traders are businesses that are not registered with the Registrar of Business and the South African Revenue Services (SARS). The economy of Mangaung makes up about a quarter of the entire economy of the Free State (Khanya-African Institute for Community-Driven Development, 2005:16).

The Mangaung Local Municipality (MLM) in 2005 came up with an informal economy policy to support the informal sector at the provincial level. Through its recognition, the following strides have already been made by the MLM in terms of support to the informal economy.

- The Mangaung Local Municipality (MLM) recognizes the informal sector as a crucial driver of the local economy and supports informal business to become micro, small and even medium enterprises (SMMEs). Prompted by the view that informal businesses should be supported and assisted to become SMMEs, the MLM came up with the following support measures.
- The MLM as already mentioned earlier has created a database of all street traders within the CBD for administration and management purposes, as well as ensured healthy trading conditions. Each registered street vendor is issued with an identity card that serves as a street trading permit. Further support measures include the allocation of street trading sites. These sites will be governed by management zones which is the link to Business Improvement districts in the CBD.

(Informal Economy Policy, Mangaung Local Municipality, 2005:41).

### 2.3.8 SUMMATIVE ASSESSMENT ON THE INFORMAL SECTOR

The informal economy continues to constitute an integral part of any economic system. Due to the inability of the formal sector to absorb the ever increasing number of job seekers, many people have sought for alternative means of earning income in the informal sector. However, considering the challenges that businesses in the sector face in terms of expansion and the potential contribution the sector can make to the national or local GDP through tax revenues, there is continued emphasis on the transition from informal to formal. The success of such a transition is also hindered by some of the challenges encountered in the transition process. This section has captured some of the advantages and disadvantages of operation in the formal sector. While the chapter argues for the benefits of operating in the formal sector, it does not ignore some of the major challenges of the process.

### 2.4 CHAPTER SUMMARY

The chapter provided an international definition of SMMEs with specific attention to its different appellation in Europe, America and South Africa. The contribution of SMMEs to socio-economic welfare was explored both at a global and national level as well as the enabling environment of SMMEs in South Africa. Further, the chapter provided a discourse around the national and provincial support agencies in South Africa. The chapter also theorised the informal sector in South Africa with a view to understand the theories governing firm transition from the informal to the formal sector. The section on the informal sector also provided a historical as well as contemporary definition of the IS, its importance, measurements and presented arguments for transition to the formal. The challenges faced by firms in their transition phase to the formal were also discussed. The chapter ended with the discourse on the informal sector support structures both at international, national and provincial levels. The next chapter presents the methodology adopted in this study.

## CHAPTER 3: METHODOLOGY

### 3.1 INTRODUCTION

In the previous chapter (Chapter 2), the literature review of the study was presented.

### 3.2 RESEARCH PHILOSOPHY

There are two main approaches to research. On the one hand is the positivist approach which originates from the natural sciences. The positivist approach to research is characterised by the testing of hypothesis developed from an existing theory through the measurement of observable social realities. Positivists argue that individuals make sense of situations based upon their expectations, memories and individual experience (Flowers 2009:3).

On the other hand, there is the *anti-positivist* approach also known as the interpretivist approach. The interpretivists focus their research on experiencing human behaviour. According to this epistemological approach, there are many different truths and meaning to a simple fact (Johnson and Christensen, 2010). Interpretivist are concerned with understanding human behaviour from the perspectives of the people on the people involved rather than uncovering general laws of relationships and/ or causality that apply to all people and at all time.

While most authors have limited their discussion of research philosophy to the two broad types discussed above, other authors have proposed a third school of thought to describe the process of inquiry called *post-positivism* (Saunders, Lewis and Thornhill, 2009:114). Born, somewhat from the frustration of both the positivist and interpretive designs, post-positivism approach takes on aspects from the other approaches to argue that, though knowledge is socially created, real structures exist independent of human consciousness (Saunders et al., 2009:114). Hence knowledge of reality is a result of social conditioning



(Saunders *et al.*, 2009:115). This form of research has been described by others as a *mixed-method* approach (Zachariadis *et al.*, 2010:4).

Research philosophy plays an important role in the choice of research design because one's research philosophy leads to a corresponding choice of research design. For the purpose of this study, the interpretivist position is adopted.

### **3.3 RESEARCH DESIGN**

Although research designs come in many ways depending on the lenses through which one is viewing the research, three research designs are discussed in this section. These include the various qualitative and quantitative designs and the mixed-method research design.

#### **3.3.1 QUALITATIVE DESIGN**

For Merriam (2009:13), qualitative research design is a process by which a researcher poses questions directly to an individual. Cooper and Schindler (2013:196) define qualitative research design as “an array of interpretive techniques which seeks to describe, decode, translate and otherwise come to terms with the meaning, not the frequency, of certain more or less naturally occurring phenomena in the social world”. This design was used as the researcher posed semi-structured questions from the interview guide directly to the interviewees.

#### **3.3.2 QUANTITATIVE DESIGN**

Muijs (2011:1) describes quantitative research design as the process of collecting numerical data which is then analysed mathematically in an effort to explain phenomena. Quantitative research makes use of detailed questionnaires that are often distributed to a very large number of people. Questions are typically structured and participants choose the most relevant and appropriate response among those listed for each question. This

approach to research collects a huge amount of data, which can often be generalised to a larger population and allow for direct comparisons between two or more groups. It also provides statisticians with a great deal of flexibility in analysing the results (Struwig and Stead, 2004:4).

### 3.3.3 MIXED METHOD

Mixed-methods designs are defined according to Creswell and Clark (2010:256) as a research design that includes at least one qualitative method and one quantitative method. It is a type of research in which the researcher uses a combination of qualitative and quantitative research designs for the purpose of depth and breadth of understanding and corroboration (Johnson et al., 2007:113).

### 3.3.4 CHOSEN RESEARCH DESIGN

Having presented the different types of research designs, it can then be argued that carrying out a research on the motives, challenges and coping mechanisms of selected transited businesses in the Bloemfontein area can be investigated either quantitatively or qualitatively or using both methods (mixed method). However, the position taken in this research is that, “people’s knowledge, views, understandings, interpretations, experiences, and interactions constitute meaningful properties of social reality” (Mason, 2007:63). That is, social reality is best captured through the views, understandings, interpretations, and experiences of actors themselves. Thus, to understand the informal to formal business transition process, it is best to see it through the lenses of the transited (‘graduated’) owners. Consistent with this interpretivist philosophical position, the qualitative approach as opposed to the quantitative or mixed method approach was adopted in executing the research.

### **3.4 POPULATION AND SAMPLING**

#### **3.4.1 THE TARGET POPULATION**

According to Kumar (2011:194) a population can be defined as the entire group of persons or set of objectives and events the researcher wants to study. A population is therefore the total collection of elements about which one wishes to make some inference.

The target population for this study consisted of all business owners in the Bloemfontein area who previously operated in the informal sector but succeeded in their transition to the formal sector. A total of 18 SMME owners selected from the list of registered businesses of the Free State Development Corporation (FDC) were interviewed.

#### **3.4.2 SAMPLING**

Kumar (2011:193) defines sampling as “the process of selecting a few (sample) from a bigger (the sampling population) to become the basis for estimating or predicting a fact, situation or outcome regarding the bigger group. A sample is a sub-group of the population that the researcher is interested in”. Probability samples and non- probability samples can be distinguished.

Welman et al. (2005:69) argue that in the case of probability sampling, the chance that any element or member of the population will be included in the sample can be determined. In non-probability sampling by contrast, one cannot specify this probability. Elements which have a chance of being included have a probability that exceeds zero. In some examples of non-probability samples, some elements have no chance (that is, a probability of zero) of being included.

The advantage of probability sampling is that it enables the researcher to indicate the probability with which sample results (for example sample means) deviate in differing degrees from the corresponding population values ( for example population means).

Unlike non-probability sampling, probability sampling enables the researcher to estimate sampling error.

So, from the discussion, both sampling methods have their advantages and disadvantages depending on how one views them with respect to the field of research and most importantly with the kind of results one wishes to obtain. Non-probability sampling is frequently used for reasons of convenience and economy but also due to the fact that some information can only be obtained from particular sources.

Since it was practically impossible to conduct one-on-one intensive interview with all the population elements, the researcher used the list of 18 business owners who “graduated” to identify other participants. This list was considered relevant because it was specifically business owners who previously were informal. The researcher contacted these business owners telephonically and those to be interviewed were noted. The researcher then asked these already identified business owners obtained from the FDC to refer other participants who were eventually included in the sample (11 of them). This type of sampling is called snowball sampling.

In this study, the focus was not aimed at obtaining a representative sample but rather on being able to capture the various perspectives from the available respondents who had managed to make the transition from informal to the formal. This reasoning justified the use of snowball sampling, a type of purposive sampling.

#### 3.4.2.1 Purposive sampling

Guarter and Barrios (2006:51) describe purposive sampling as a non-random selection of sampling units within the segment of population with the most information on the characteristic of interest. According to Cooper and Schindler (2013:406) purposive sampling is a sample that comprises experts only. Here, researchers rely on their experience to select people with known or demonstrated expertise in their area of interest. Researchers also use their expertise on the selected people to deliberately obtain units

of analysis in such a manner that the sample they obtain may be regarded as being representative of the relevant population.

The researcher approached many organisations dealing with company registration to solicit the names of registered businesses and their contact details in order to select those who previously were informal. The FDC happened to be the only organisation that furnished the researcher with a list of 18 informal business entrepreneurs who had managed to make the transition to the formal sector. These business owners were then contacted telephonically for interviews.

#### 3.4.2.2 Snowball sampling

In the first phase of snowball sampling, the 18 entrepreneurs from the relevant population were approached. The researcher intended to interview all of the 18. However, out of these 18 business owners, only two (2) responded favourably to the researcher's telephonic request for interview. From these two (2), the researcher was able to get the contact details of friends (11) of the interviewed business owners who like them succeeded in the transition from the informal to the formal sector. The researcher ended up interviewing 13 business owners in the Bloemfontein region who successfully made the transition from the informal sector to the formal.

### **3.5 DATA COLLECTION**

The first phase of the research was a review of secondary literature on the topic. In the second phase, one-on-one in depth interviews were held with the 18 participants. The one-on-one approach was used because businesses usually prefer to keep their information secret and will not want to share them with others. Specifically, the research posed semi-structured questions, listened attentively to responses and used a tape recorder to capture the accounts of respondents, and then transcribed and interpreted the accounts of respondents.

### **3.5.1 INTERVIEWS**

Semi-structured interviews were used in this study. The interview guide involved a list of open-ended questions covering the research questions. These open-ended questions were for the purpose of not restricting or limiting the interviewees' ability to express their views while providing answers to the questions being asked. The themes in the open-ended questions were the owners' background information, reasons for becoming formal, challenges encountered during the process of formalisation, coping mechanisms of owners and strategies to reduce the challenges faced during the transition to the formal.

After the interview guide was designed by the researcher, some piloting was done with two business owners who successfully transitioned from the informal to the formal sector. The aim of the piloting was to make sure all questions were clear and unambiguous as well as provided the researcher the opportunity to check for reciprocal understanding of the questions. The interview was a one-on-one, face-to-face interview. This was done to create a serene environment where the respondents could talk freely and feel secured. With the consent of the respondents, the researcher recorded the interviews with the help of a tape recorder.

### **3.6 DATA ANALYSIS**

After listening to the recorded responses of the interviewees, the data collected was then transcribed and categorised into different themes. After analysing the data by themes, codes were systematically assigned using words and inferences were drawn from the text.

### **3.7 CHAPTER SUMMARY**

The chapter has provided a description of the different approaches to scientific research and inquiry. It first examined various philosophical schools of thought regarding the process of social research and employed a qualitative research approach. The choice of

a qualitative design leans to the type of research questions being asked. The limited availability of respondents led to a qualitative study. The next chapter presents findings from the qualitative data which has been analysed and discussed around key themes as identified in the data analysis process.

## **CHAPTER 4: RESEARCH FINDINGS**

### **4.1 INTRODUCTION**

The previous chapter presented a detailed description of the methodology applied to this empirical study. This chapter presents the main findings using core themes developed from the data analysis process. The unit of analysis was an individual entrepreneur or manager of the business. Each individual provided a detailed account of the transition of the businesses from the informal to the formal sector.

Key indicators applied in the analysis included the motives, challenges and coping mechanisms of selected transited businesses in the Bloemfontein area. The first part of this chapter recaps the research questions. This is followed by a descriptive analysis of the process of transition using perceptions and experiences of entrepreneurs. The last section highlights the implications of the findings for corporate policy / for corporate practice.

### **4.2 RECAP OF THE RESEARCH QUESTIONS**

1. What are the main motivations for the decision to formalise previously informal businesses?
2. What challenges do the transited businesses experience in their transition to the formal sector?
3. What personal traits do informal business owners draw on in dealing with challenges of transition?
4. What strategies can be put in place to reduce if not eliminate the challenges of transition from informal to formal business?



### **4.3 DEMOGRAPHIC PROFILE ANALYSIS OF RESPONDENTS**

This section presents the demographic profile analysis of the respondents across three main characteristics: gender, nationality, and levels of education. Characteristics of sampled businesses by sector will however be presented before the demographics.

#### **4.3.1 CHARACTERISTICS OF SAMPLED BUSINESSES BY SECTOR**

Analysis of the data showed that interviews were done on SMMEs across eight (8) sectors. These are the retail, information technology, tourism, manufacturing, hospitality, networking, corporate training and hair dressing sectors. The total number of respondents for this study was 13. The retail sector formed the majority of the respondents making 3 out of all 13 respondents. SMMEs from the manufacturing, Hospitality, network marketing and hair dressing each represented 1 of the sample while IT, Tourism and corporate training represented 2 each. The data shows that arguably, the retail sector forms a strong base of SMMEs in the province. An earlier study on SMMEs as a percentage of formal company registration by Atkinson (2012:10) in the Free State province revealed that the retail sector formed a strong base of SMMEs in the province of Bloemfontein. It should however be noted that this retail sector was second after the financial and business service which was not consistent with this study. Mofokeng (2005:5) warns that business sectors especially in the informal economy could be very contextual and differ from one part of the world to another.

#### **4.3.2 RESPONDENTS BY GENDER**

In relation to gender distribution of the respondents, a total of 10 males and 3 females were interviewed. Of the 10 men interviewed, eight were foreigners (non- South Africans) and formed the majority of the male respondents while male nationals (South Africans) were only 2. No female foreigner was interviewed. Since the focus of the research is on the transition of firms from the informal to the formal sector in general without a keen emphasis on the number of foreigners and nationals in this sector, the respondents were

simply presented by gender. The male respondents formed a majority of 10 of all the respondents while female respondents formed only 3 of all the respondents as presented in the diagram below.

The researcher observed that male respondents were more open to discussing their experiences and achievements as opposed to the female respondents. The female respondents for some unknown reason were reluctant to be interviewed resulting in a significant limitation of females in this study regarding gender representation. Nevertheless, this gender distribution corroborates a study carried out by the African Institute for Community-Driven Development (2005:4) in Mangaung which revealed that there were far more (70%) male business owners operating in the informal sector than females (30%) The finding consummates that of Leino (2009:1) which also revealed that female entrepreneurs are less likely to operate in the informal sector, with 38% of informal businesses owned by women. This finding apart from being context-based, relates to access to capital and education based on gender.

The findings contradict evidence from OECD (2006:28) which estimated that 84% of workers in the informal sector are women as opposed to the 16% minority which are men. This could, however, be accounted for by the context (sub-Saharan Africa) of the study.

#### 4.3.3 RESPONDENTS BY LEVEL OF EDUCATION

Further analysis of the data reveals that the level of education of the respondents varied from below matric to post graduate. Based on the analysis 2 of the respondents had a level of education below matric, 5 had matric, 1 post-matric, 1 a degree and 4 were post-graduates.

#### 4.3.4 RESPONDENTS BY NATIONALITY

The informal sector in the Bloemfontein area is largely characterized by the presence of foreigners. These foreigners include; Basothos, Bangladesh, Cameroonians, Congolese,

Eritreans, Ethiopians, Ghanaians, Nigerians, Somalians and Zimbabweans. Of the 13 businesses that succeeded in the transition from the informal to the formal sector, 8 were foreigners while only 5 of the respondents were South Africans.

#### **4.4 EMPIRICAL FINDINGS**

This section provides an analysis of the respondents' responses. All the respondents interviewed stated they started their businesses in the informal sector and operated in this sector for quite some time (2-15years) before eventually moving into the formal sector. In total 4 respondents operated in the informal sector for less than 10years while 9 respondents operated in this sector for more than 10years. The reasons for these firms' desire to become formal will be discussed in the next section.

##### **4.4.1 MAIN REASONS TO FORMALIZE**

From the literature, the process of formalization of firms is affected by and or motivated by diverse reasons. This section unravels some of the reasons as highlighted by the respondents. Findings have been corroborated with previous studies to ensure reliability. Common findings accounting for the reasons to formalize included; growth and expansion, access to proper banking services, government contracts and tenders, access to bank loans and trust from customers/ suppliers. Almost all the above mentioned reasons were reiterated by all respondents which was captured in one respondent's words as follows:

*“When the capital grows, you have to think of doing things the right way; you have to do things according to the law. The second thing is that you got a lot of advantages when you operate in the formal sector like access to credit, proper bank account, and other things like having trust from customers or suppliers”.*

(Female South African, post graduate).

#### 4.4.1.1 Growth and expansion

All the respondents pointed out that their motivation to move from the informal sector to the formal was prompted by their desire to grow. On growth as a motivation to formalize, respondents mentioned the desire to expand their businesses to other provinces. A male foreigner with post graduate qualification commented:

*“The formalization of our businesses makes it easy for us to explore other business ventures in the province, for example if I open the first shop here in Bloemfontein and it is booming, I will open another one say in Thaba-N’chu which will be managed by one of my brothers. If the shop happens to be successful there as well, the cycle will continue till my brothers and I eventually have shops in almost all the localities and why not provinces”.*

The fact that all businesses in their transition process mentioned the desire to grow as one of their main reasons to become formal is a clear indication that there are benefits that accrue to enterprises as a result of growth. A report on developing and transition countries compiled by OECD (2006:28) suggests that the desire to grow prompts firms to become formal. Formalization by itself however according to this OECD report only promotes growth in the long term. The same report warns that “While formalization by itself does not promote enterprise growth in the short run, bringing more enterprises into the formal economy over the long term should provide higher quality, better paid and more sustainable jobs” (OECD, 2006:28).

#### 4.4.1.2 Access to banking services

Access to a proper bank account to run a formal business was another reason for formalization. One respondent said:

*“If I do not formalize my business, I cannot even open a bank account as a business. I can only deal with it as if it was a personal account” (South African female, post- matric).*

Another respondent stated:

*“I have to be traceable meaning I must have a proper bank account to show that I am operating legally. Also, I cannot have access to loans if I do not have a proper bank account”* (Male foreigner, matric holder).

The evidence above suggests that having a proper bank account is a major incentive for firms that want to become formal and for those that eventually do.

The International Finance Corporation (2013:22) argues that all business owners need a proper bank account in order to operate legally. The International Finance Corporation (2013:22) also argues that business owners who began operations in the informal sector urged by the survivalist motives (necessity firms) need proper bank accounts to run their businesses.

#### 4.4.1.3 Access to bank loans

About 38% of the respondents mentioned access to bank loans as one of their reasons to become formal. Following is a quote from a national respondent.

*“If I am not in the formal sector, I do not have access to bank loans, so how will my business grow?”* (South African female, matric).

According to another South African national (Male):

*“One of my reasons for becoming formal was to have access to bank loans. The informal sector does not provide enough capital for expansion and the fact that people in this sector are not legally recognized makes it very difficult or almost impossible for them to get bank loans. When you formalize your activities, you enjoy the right of applying for a bank loan which is very necessary for things like renting a business place and paying workers. This loan is a good support at*

*least till the business is able to make enough cash to take care of itself” (South African male, matric).*

However, only South African nationals mentioned access to bank loans as a motivation for their reason to formalize their activities and none of the foreigners mentioned this as their reason to become formal. A closer analysis of the conditions for accessing bank loans in South Africa justifies the lack of access to bank loans. South Africa banks do lend money to foreigners on the basis of the following conditions being met:

- Possession of a valid work permit by the foreign applicant.
- In terms of Exchange Control Regulations, the foreigner applicant must repay all the liabilities before they leave South Africa.
- The foreigner applicant must comply with Exchange Control regulations (a bank representative at a branch will be able to help with this process) and
- He/she must have a contract with the employer.
- The South African Reserve Bank regulations on its part stipulate that “foreign nationals who have a valid work permit issued by the department of home affairs to work in South Africa may apply for loans. Banks have their own credit policies with regard to affordability and credit risk, which may have an impact on the application. Should clients need to return to their own country, they will need to repay the loans prior to leaving South Africa” (Standard bank, 2011).

The above explanations by standard bank in the country and the reserve bank explain why only nationals and not foreigners mentioned access to bank loans as a motivation to go formal. This reason is explained by the fact that very few foreigners interviewed qualified for a loan based on their credit records. Those who qualify for a loan unfortunately do not have enough collateral to access the loans. The argument here is that South African businesses or entrepreneurs in the informal sector were motivated by

the desire to access loans as a motivation for going formal. Luebker's (2008:351) study on informal employment in Zimbabwe (Harare) confirms that firms or businesses in the informal sector do not have access to bank loans because of their lack of legal recognition. Luebker (2008:351) supports his claim by pointing out that the loan and credit application process presents enormous challenges to credit access for those in the informal sector. This finding had been earlier been observed by Becker (2004:22) who found that because of their hidden nature, businesses in the informal sector cannot access resources which institutions such as banks provide.

Bashe (2012:24) draws attention to the realization that the provision of credit is very far from being a one-size-fit-all situation. This is so because the terms and conditions of a bank credit facility for businesses in the formal sector may not be applicable for enterprises in the informal sector.

Fajnzylber et al. (2010:46) agree with Becker (2004); Luebker (2008); and Bashe (2012) by pointing out that the formalization of firms turns out to be decisive for access to credit. Larger firms both in terms of the value of fixed assets and the number of employees are perceived by McCulloch et al. (2010) to be more likely to have more credit than smaller firms due to their asset base and easy traceability.

Drawing on evidence from the World Bank Enterprise Surveys in the informal sector across 15 developing countries, International Finance Corporation (2013:23) suggest that one of the leading challenges cited by firms in the informal sector is access to bank loans. The inability to access bank loans obstructs the growth and sustainability of enterprises in the informal sector, with the problem becoming more severe as the firm grows in size. This thus pushes businesses in the informal sector to formalize.

Basu et al. (2004:8) point out that Micro Finance Institutions (MFIs) have been established in Tanzania and Ghana in order to respond to the desire to access loans by businesses in the transition process to the formal sector. These MFIs' have been defined as "financial

institutions established for the benefit of small enterprises, the informal sector, the poor, and households who have been barred from access to formal sector establishments. These MFI's depend on high frequency of payments, short maturity deposit and occasionally a compulsory security deposit to reassure timely loan repayments (Basu et al., 2004). The failure of financial institutions owned by the government to provide bank loans to people in the informal sector emphasizes the significance of a financial system for the enterprise development of the informal sector (Bashe, 2012:21).

#### 4.4.1.4 Access to government contracts and tenders

All the national respondents with post-matric qualifications and above mentioned access to government contracts and tenders as one of their main reasons to transit from the informal sector to the formal. One respondent argues that:

*“When I was running my business informally, it was difficult to get big contracts and/or tenders because big government projects, contracts and tenders require registered businesses only”* (Male foreigner, post graduate).

The desire of many businesses to become formal is driven by the need to have access to government contracts/tenders, which gives access to finance and ensures the relative sustainability of the company. From the interviews, the researcher observed that though many businesses will want to contract with the government, it is rather unfortunate because government contracts are long term. The company contracting with the government is most of the time required to supply its services first to the government and usually only gets paid after a period of time later. Personal investment is therefore required by the company that is contracting, which on its own is a financial limitation to many businesses. This frustrates the dream of many formal businesses to access government contracts and tenders.



However, McCulloch (2009:18) argues that the formalization of businesses does not improve access to government contracts as small businesses are not main suppliers for local governments. To the contrary, ILO (2013:9) observe that many SMMEs have been motivated to regularize their status in order to gain access to government contracts and tenders due to strict government regulations on contract and tender awards.

#### 4.4.1.5 Trust from customers/ suppliers

Another reason for the transition of businesses from the informal sector to the formal as mentioned by respondents is trust from customers/suppliers.

*“Formalization gives you an identity, confidence and trust from customers/suppliers when dealing with you”.* (South African male, matric)

Another respondent concurred as follows:

*“When I approach a supplier and I do not have a business bank account, tax number, do not have a business name, most of the time they do not trust me”.* (Male foreigner, degree).

Remkho (2013:8) asserts that a systematic approach for managing and developing partnership with a limited supplier should be based on trust. Trust is fundamental for supplier relationship management and is key to drive a company's competitive advantage.

The above reasons for formalizing a business can be surmised in one response offered by a South African national (female, post graduate) suggested that:

*“I registered my business because I cannot access markets if I am not registered, I cannot operate legally if I am not properly registered and do not have a required license. The most important thing is that the formalization or registration of a business gives me an identity and*

*confidence to my clients in dealing with them. Another thing is that if I am not registered, I cannot even open a bank account as a business, I can only deal with it as it was a personal account. In that manner, I am not growing. I cannot borrow money from the bank. In a nutshell I have no identity if I am not registered”.*

Besides the above mentioned reasons for formalization mentioned by the respondents, several other reasons for formalization were identified by McCulloch et al. (2010:9), and they include the following; access to legal dispute resolution mechanism such as courts, access to markets and the facility to enter into collaborative agreements with large firms. The above mentioned authors also argued that none of these benefits are typically available to informal firms.

The above mentioned reasons to formalize a business, confirm the observation by the International Labour Organization (ILO). According to the ILO (2009), businesses in the informal sector have limited resources which cause them to face greater obstacles in accessing markets, financial and non-financial services and government procurement. (ILO, 2009: 4). A similar study conducted in Brazil revealed that a major reason for businesses to move to the formal sector is the desire not to pay fines (Jaramilo, 2009:4).

From the above mentioned reasons for formalization elaborated by respondents, it can be concluded that transition and formalization to the mainstream economy are desired goals.

#### 4.4.2 SUPPORT STRUCTURES THAT ASSISTED DURING FORMALIZATION

From analysis of the data it was observed that there were two main support structures which businesses benefitted from in their transition process. The first was through formal support structures such as the FDC, SEDA and the Mangaung Municipality while the

second was through informal support structures which were mostly mentioned by foreigners.

#### 4.4.2.1 Formal support structures

One of the main support structures mentioned by many respondents was the **Small Enterprise Development Agency (SEDA)**.

When asked from which support structure they (businesses that succeeded in their transition from the informal sector to the formal) got assistance during the process of formalization, the common response was from SEDA. As already mentioned above, none of the foreigners interviewed acknowledged to have received assistance of any kind from the SEDA. From the nationals interviewed, only those with an education level above matric acknowledged to have received assistance from SEDA. It was reported that the assistance given by SEDA was in the form training, workshops and registration.

*“I did get assistance from SEDA. SEDA actually developed my business plan. From SEDA, I also got assistance on how to run the hospitality business, also workshops were organized and I was even taught on the registration process.”* (South African female, post matric).

Another formal support structure from which respondents did benefit from assistance was **Free State Development Corporation (FDC)**. Some respondents reported to have received financial assistance from the FDC in the form of a loan. One of the respondents mentioned that:

*“I did get financial support from the FDC. FDC assisted me with a loan which was only transferred once I got my registration licence”* (South African female, post-graduate).

Financial support from the FDC in the form of a loan was also mentioned by many in the same light as the respondent above.

The **Mangaung Municipality** also provided support to some SMMEs during their transition phase. From the interviews, only one respondent mentioned to have received assistance from the Mangaung municipality in the form of workshop and training during the process of formalization.

Apart from the MLM, SEDA and the FDC both offered training to some businesses in their transition process. Training offered to businesses transiting to the formal sector is very important because a majority of firms fail in their first years for lack of core skills such as management skills, financial and other core skills hence the need for training. The need for training is supported by Bowen, Morora and Mureithi (2009:16) who point out that education or relevant training is related positively to business success.

Another thing that emerged from the interviews is that all the nationals that received assistance from any support structure had an education level above matric. Only the national respondents were aware of the support structures and actually benefitted from these support structures (all 3 South African females). These nationals that got assistance from SEDA, FDC and the Mangaung Municipality did not only successfully transit their businesses to the formal sector but are also doing good business today. Below are two examples of enterprises that transited from the informal to the formal sector owned by a female national and a foreigner respectively.

To demonstrate the transition from the informal sector to the formal sector some vignettes of such transition will be provided to illuminate the findings of this research. The first example of an enterprise that “graduated” from the informal sector to the formal sector is that of a female national whose identity will not be revealed for ethical reasons but for the sake of this study will be attributed the pseudonym Thandi. Thandi is a South African female national with a Masters in Governance and Transformation. She started her

private hospitality business in 2003 informally. She converted her private residence into a guest house but she could not access markets because she was not registered. The desire to access markets coupled with her desire to grow prompted her to register her business. Having obtained support from FDC in the form of a loan, SEDA assisted her with designing a business plan, workshops and training. Thandi finally registered her business in 2009 and owns one of the busiest guest houses in the city of Bloemfontein today though still working for the government.

The second example of an enterprise that successfully transitioned from the informal to the formal sector is that of Prosper, a foreign national with a degree in Economics (Cameroonian male, degree). After finding himself several times out of work, he decided to get into own business. He migrated to South Africa more than a decade ago. Due to lack of capital, he started his business as a street vendor and later owned a grocery store but still was informal. His business started in Johannesburg but the market for his activities became saturated due to the presence of many other foreigners doing the same thing so he moved to Bloemfontein to explore new avenues.

In Bloemfontein, he started the furniture business which grew in a short space of time. The growth of his business and the desire to expand led him to register his business. Having won the trust of his suppliers, he could get furniture and accessories on credit. Thanks to his suppliers, Prosper is now the proud owner of “Modern Furniture” in Central Bloemfontein and has opened several other shops across the town and has even opened new ones in the neighbouring towns in the Northern Cape Province. Today, this business owner has purchased machines and is about to manufacture his own brand of furniture in his own factory.

From the evidence above, it can be seen that there is correlation between successful business and the level of education. In concurrence with this observation, Van der Sluis and Van Praag (2008:15) argue that there is a positive correlation between the level of education and entrepreneurship performance. Van der Sluis and Praag (2008) are

supported by McCulloch et al. (2010), who state that “we find strong evidence that better educated owners/ managers are significantly and sizably more likely to formalize their businesses. Daniels (2011:12) strongly supports this view as he argues that entrepreneurship skills allows for swiftness to swiftly amend their (SMMEs) production methods according to their resources and materials at hand. Daniels also argues that entrepreneurship skills allows for versatility and quickness to adjust to the customers’ ability to pay. The fact that only nationals with an education level above matric were aware of and benefited from support structures does not mean that these structures are closed to the less educated ones. This could rather be attributed to the correlation between the level of education and business success as already elaborated by Van der Sluis and Van Praag (2008:15) above.

A study conducted by Lee Chang and Baelim (2005) on the effects of entrepreneurship education on American and Korean students revealed that Korean students had the ability to acquire similar qualities and entrepreneurship after embarking on entrepreneurship education. The result of the finding was that entrepreneurship skills can be learnt.

With entrepreneurial skill regarded as a process of productivity and change, Bashe (2012:22) suggests that “educational institutions should amend their curriculum to enable students to develop their right brain entrepreneurial capabilities as well as their left brain analytical skills”. Bashe’s (2012) suggestion therefore calls for the need for business schools and technical institutions to encourage and promote the entrepreneurial imagination.

One can be tempted to say that since the mandate for these institutions works more for nationals; it explains why the institutions did not offer support to businesses operated by foreigners as previously discussed above. In spite of the non-assistance to foreigners from the SEDA, FDC and the Mangaung Municipality, foreigners used their informal support among themselves such as borrowing from friends and relatives to help them make the transition.

Another limitation of these support structures is the fact that these support structures only have their offices in the Central town making it difficult for those in the rural areas to be aware of their existence.

It was noted from the interviews that no foreigner received assistance from any formal support structures. One of the foreigners however accounts his experience as follows:

*“I went to SARS for assistance during the process of registration and they refused to assist me when they found out that I was a foreigner. It is difficult to get assistance from the government as a foreigner. The government gives us no support as they only give support to their nationals”* (Male foreigner, post-graduate).

#### 4.4.2.2 Informal support structures

According to a foreign respondent:

*“Since we cannot have support from neither the government nor any of the support structures put in place to assist with the process of formalization like SEDA for example, we either go straight to SARS through a shelf company. This shelf companies works in close collaboration with SARS but are more expensive. The shelf company takes all our details to use for the company registration and after 4 weeks if I am not mistaken the applicant has the feedback in terms of registration outcome and the certificate of registration”* (Male foreigner, degree).

According to the foreign respondent, while foreigners could not get support from the formal government structures, they however developed other forms of assistance to support them in their quest to make the transition from the informal sector to the formal.

These included other informal support structures like *njangi* or *tontines* (monthly contributions) and borrowing from friends and family members.

Bashe (2012:10) sees the importance of foreigners as he argues that the informal sector is made up of immigrants from different countries. These immigrants come along with innovation, competitiveness and a diversity of products offering their customers a variety of products to choose from.

#### 4.4.3 CHALLENGES ENCOUNTERED IN THE FORMALIZATION PROCESS

Many challenges to the process of formalization persist but what came out from the interviews in this case was the challenge of long queues during the process of formalization, access to finance, lack of adequate and relevant information and the lack of government support. These challenges have been discussed below.

##### 4.4.3.1 Long queues

Many challenges were mentioned by the respondents. The dominant challenges were the long queues faced during the process of formalization- the lengthy, complex and time consuming process of formalization, access to finance and the lack of proper information and training on the process of formalization. The following is the citation of one of the respondents that captures the sentiments of most of the respondents.

*“As I already mentioned, lengthy process and follow ups because The South African Revenue Service (SARS) did not send me the documentation which takes about 7 weeks. SARS does not keep you updated, in case of any information you want to find out, you have to go to their office. You don’t get something like SMS or email to inform you on the progress of your application” (South African female, post-matric).*



Nine (9) of the respondents mentioned long queues, lengthy, complex and time consuming process as the challenges they faced during the process of formalization. Just the thought that one might spend the whole day at SARS waiting in the usual long queues to be registered has scared so many business owners in the informal sector. A respondent reported the following.

*“When you go to SARS for registration you spend the whole day in the queue with no a guarantee that you will be granted assistance at the end of the day. This is very frustrating because the time spent there is a big loss for my business”* (South African male, matric).

The time factor is very important for small business owners since they are uncertain of when a customer would come so rather they would spend time on their business premises than wait in long ques. Other respondents lamented as follows.

*“Because of the complex and time consuming process of formalization, they resort to shelf companies who unlike SARS charge more money but spare them the trauma of registration which SARS offers”* (Male foreigner, matric).

McCulloch, Schulze and Voss (2010:18) highlight the above claim by arguing that long queues is a challenge faced by firms in the informal sector but also emphasize on registration fees as a challenge. According to McCulloch et al., (2010:18) each business that wants to “legally” open or register an already existing business faces an initial entry cost in terms of fees and time. On what determines a firm’s decision to formalize, McCulloch et al., (2010:18) reveal that besides direct taxes paid to the government, the firm also has to incur indirect costs in the long queues and the time spent in fulfilling product or labour standards or the time spent in submitting government documents. Anecdotal evidence by Ishengoma and Kappel (2006:16) suggests that an important reason for firms to formalize is to diminish illegal payments to business inspectors.

A study carried out in Brazil revealed that the most frequent challenge faced by businesses willing to formalize is the burdensome and costly procedures involved during the process of formalization (Jaramillo, 2009:14). It is interesting to note that the study in Brazil on the transition of firms from the informal sector to the formal yielded the same results as the current one in Bloemfontein, in South Africa. One can arguably say that Brazil and South Africa are both countries in the BRICS and the fact that they have similar findings and results pertaining to the challenges faced by businesses willing to formalize is however a mere coincidence because though the context is the same, the conditions are very different. Abdelhamid and Mahdi (2003:1) had the same view as they pointed out that the most common challenge faced during the process of formalization is the expensive, cumbersome and complex entry regulations primarily imposed by the government and their associate legal apparatuses.

#### 4.4.3.2 Access to finance

Access to finance remains a major concern for businesses in the informal sector. This lack of finance causes some to resort to financial contributions such as **tontines** or moneylenders for emergency loans (ILO, 2009:31). A view supporting Bashe's (2012) claim argues that the lack of conventional sources of finance by firms in the informal sector pushes some to resort to loan sharks (Tsai, 2004).

#### 4.4.3.3 Lack of proper and adequate information

Lack of proper and adequate information is another challenge mentioned. It was unanimously stated that there is lack of proper and adequate information on the need to become formal. This lack of information also reduces and limits the number of firms that transit to the formal sector.

#### 4.4.4 PERSONAL ATTRIBUTES NEEDED TO DEAL WITH CHALLENGES

When asked what advice these business owners who succeeded in their transition to the formal sector could give someone in the informal sector willing to become formal, the responses were very subjective.

It was reported by some respondents that the personal attributes critical to the transition to the formal sector include adequate information and self-trust.

*“The person needs to be informed, they need to do research (business research on how to start-up a business) which is available on the internet. I find the internet offers a lot of help”.*

*“Self-trust and the person needs to be focused because according to me this is what makes many not to be confident about going to the formal sector. If I really want to do something, I take the pain to explore it. Be inspired, self-motivated and have the courage to move on irrespective of failure because one cannot know success if one has not failed before. The other thing is never think that you are great because people who think they are great stop striving for better things. I also think the person needs to expand his brain while always being observant. By being observant, I think there are many things which a person will pick up for his own good. For example, I am in the hospitality business and when I go to public places attended by many, I always check what the arrangement is like, what the painting is like and often ask questions like who did the paintings. I will also copy from others so as to improve because you can never be self-sufficient”*  
(South African female, post-graduate).

To add to the self-trust, *discipline*, *enthusiasm* and a *sense of belonging* can be drawn from most of the respondents on whether to formalize the informal sector or not. Bashe (2012:79) concurs that discipline, enthusiasm and a sense of belonging are the core characteristics needed by businesses. According to Bashe (2012:79), these characteristics (discipline, enthusiasm and a sense of belonging) are missing in businesses operating in the informal sector and are crucial for transiting into the formal sector.

#### 4.4.5 STRATEGIES TO DEAL WITH CHALLENGES OF FORMALIZATION

When asked what strategies could be put in place to reduce the challenges of formalization, the majority of the respondents said the government should intervene via the municipality while others mentioned that SARS must work in close collaboration with the banks to help them (transiting businesses) open bank accounts.

According to one of the respondents,

*“The government through the Mangaung municipality should go down to the people in the informal sector, inform and educate them on the process of formalization. The government should also re-group the people in the informal sector, help them form a company and then register them”* (Male foreigner, matric).

Another respondent said:

*“The government must create an awareness campaign through its local government by going down to the municipalities to assist people in the informal sector with the right information about becoming formal. The government should also make sure that these people qualify to be registered because some people have registered businesses which do not exist. The government can do that itself or send trained and competent bodies to assist those in the informal sector with registration process”* (South African female, post-graduate).

Still in line with government intervention, a respondent disclosed that:

*“SEDA organizes training but many people do not push themselves to attain. If the government via its Municipality can go to those business owners still operating in the informal sector and invite them to attain the training, I think it will be a plus”* (South African female, post-matric).

Another respondent pointed out that:

*“I think if maybe there could be officials within SARS or any other registering body in the province like the SEDA or the municipality that can help working clients through the internet to process their applications. By showing people how to register themselves on the internet I think this will help reduce the long queues faced during the process of formalization”* (South African male, matric).

This respondent also stated that:

*“These registering offices (SARS, municipality and SEDA) should have satellite offices in all the provinces because some provinces do not have these registering bodies, so informal businesses have to go to bigger provinces for registration. The introduction of satellite offices in all the provinces will limit the number of people going to big provinces for registration which used to be a challenge, thereby increasing the number of registered businesses in the provinces. These registering bodies apart from having satellite offices could also think of having even mobile offices in the form of a small bus equipped with a computer and an agent to register the people. They (registering bodies) should also make their presence felt in rural areas as well”* (South African female, post graduate).

Another again mentioned that:

*“Workshops should be organized for people still in the informal sector during which they are informed on the process of registration. Workshops, I think are good forums for those in the informal sector to express their challenges and queries while also being a good forum for them to be educated further”*(Male foreigner, post graduate).

It should however be noted that the issue of workshops already existed during the Mangaung Municipality but it needs to address the issue of formalization more rather than just focusing on creating jobs. When interviewed on the strategies put in place to reduce the challenges of formalization, it was reported by a respondent that:

*“I know here in the Mangaung municipality there is some kind of workshop but I have never attended. These workshops are mostly about creating jobs”* (Male foreigner, post graduate).

It was again suggested by another respondent that:

*“There should be a door-to-door information campaign about the essence of formalization from time to time not only to inform the people in the informal sector but more so to keep on reminding them”.*

Evidence of this kind of informational campaign has been pointed by a respondent who argued that:

*“SARS sometimes go round and make door-to-door campaigns. They (SARS) did approach me twice while I was still in the informal sector and three years back again I was approached while already operating in the formal sector. The SARS officials conducting the door-to-door informational campaign provided us with brochures and pamphlets”.*

This respondent pointed that this is not enough because of the irregularity of the campaign. This campaign could be more of help if carried out on a regular basis say every three or six months. It is however a way to inform people about the formalization, even those in the rural areas.

When asked what strategies could be put in place to reduce the challenges of formalization, one of the two Ethiopians said:

*“The government could help us (Ethiopians) with at least a 2 year permit which is called a status and can be renewed after 2-3 years. This status will make things better for us. Also SARS needs to know that with the exception of those of us who married South African ladies in order to have the right documents, all of us (Ethiopians) only have the asylum status which does not allow us open a bank account. If SARS works in close collaboration with the bank to allow us open accounts with the asylum status, this will help our business to be more secured not only because no police will come bother us again on issues of registration, but we as the Ethiopian community will be able to also save our money in the bank as opposed to our custom of saving money with us”.*

Another respondent acknowledged that:

*“The government should intervene in the informal sector to help those that are willing to formalize their operations. I say so because I think that the government and the municipality have not been very supportive in helping people in the informal sector who show interest of quitting the sector and become formal”.*

The findings of a study conducted by the International Labour Organization on the formalization of businesses reveal that small enterprises are naturally absent from the

policy-making process due to their lack of effective advocacy means. As a consequence of the lack of effective advocacy means, these small enterprises tend to face greater obstacles to accessing financial and non-financial services, government procurement and accessing markets. The cost of operating in the formal sector is often prohibitive and the regulatory framework is usually hostile. It is therefore of great importance that small enterprises are given a voice in the policy process, strengthening the capabilities of their organization. The ILO project supports small businesses' concerns by funding radio stations that channel their demands to policy makers and this demonstrates an innovative way of giving the operators of the informal sector a voice in the policy reform process. These policy makers respond via phone – broadcasts (ILO, 2009:31).

#### **4.5 CONCLUSION**

The main research questions were answered in this chapter. The findings suggest that the transition of firms from the informal sector to the formal is feasible with some practical examples of “graduated businesses”. The feasibility of this transition however depends strongly on the intervention of the government in the informal sector. Government intervention in the informal sector is imperative because there is a crucial need for the people in the informal sector to be educated on the importance of becoming formal. Education here also implies the need for the government to inform the people about the support structures which they have put in place to assist and support SMMEs desiring to become formal.



# **CHAPTER 5: CONCLUSIONS, IMPLICATIONS AND RECOMMENDATIONS**

## **5.1 INTRODUCTION**

The previous chapter presented the major findings of the study. This Chapter first provides conclusions based on the main findings followed by recommendations for policy, practice and further research.

## **5.2 CONCLUSIONS**

To recap, four research questions were posed in this study regarding the (i) motives; (ii) challenges; (iii) personal coping attributes; and (iv) strategies to reduced challenges of formalising an informal business.

Based on the international and the South African literature reviewed in Chapter 2, it is concluded that the transition of businesses from the informal to the formal sector can be hazardous. On the empirical study, the following conclusions were arrived at.

### **5.2.1 MAIN MOTIVES FOR FORMALISATION**

On the motives that propel an informal business to formalise, interpretations of the results as presented and discussed in Section 4.4.1 leads to the conclusion that informal business owners in the Bloemfontein area were largely motivated by: (i) the desires to grow and expand; (ii) the need to have access to banking service; (iii) the necessity to gain access to bank loans; (iv) need to gain access to government contracts; and (v) need to gain greater trust from customers and suppliers.

### **5.2.2 MAIN CHALLENGES FOR FORMALISATION**

On the main challenges encountered by informal businesses in Bloemfontein in their formalisation journey, interpretation of the accounts of respondents as reflected in Section

4.4.3 leads to the conclusion that long and time consuming queues especially at the SARS office and lack of clear information on the formalisation process pose the greatest challenges.

### 5.2.3 PERSONAL TRAITS FOR DEALING WITH FORMALISATION CHALLENGES

Regarding the personal attributes most relied upon by owners to deal with challenges of formalisation, the results in Section 4.4.4 leads to the conclusion that: self-belief; courage; discipline; enthusiasm; as well as ability to seek and find information are the most crucial factors.

### 5.2.4 STRATEGIES FOR DEALING WITH FORMALISATION CHALLENGES

Finally, on the basis of the results in Section 4.4.5 it is conclude that the following two strategies can be useful in dealing with the challenges of formalisation. Firstly, local municipalities and other support agencies should educate those in the informal sector on the process of formalization. Secondly, local municipalities and other support agencies should provide those in the informal sector with clear information on the process of formalization. Therefore, local municipalities and support agencies like Seda can be the main vehicles through which the challenges of formalisation can be reduced if not eliminated. This also leads one to conclude that as far as the 'graduated' small business owners of Bloemfontein are concerned, local municipalities and other support agencies are not performing their supportive roles adequately.

## 5.3 IMPLICATIONS OF FINDINGS AND CONCLUSIONS

### 5.3.1 PROCESS OF FORMALISATION

A major implication of the study as observed from the findings relates to the process of formalizing businesses in South Africa. One of such findings provides arguments that the formalizing process of businesses needs to be better managed to minimize the long queues inherent in the process which could discourage some businesses who have

considered formalizing. The government and other supporting agencies will need to restructure the process to enhance fast process of formalization.

### 5.3.2 SUPPORT STRUCTURES

Next, business support agencies would have to increase their visibility and role in sensitizing members of the public as well as informal business owners of the advantages of formalizing as well as providing incentives for newly formalized firms. These incentives could be in the form tax holidays to help the newly registered businesses manage their finances properly and prepare them for tax declaration and other business-related activities which hitherto did not include formalization.

Chapter 2 of this thesis provided a detailed discussion of the support structures or agencies put in place by the government to assist business owners in the informal sector willing to become formal. These agencies operate both at a national and provincial level. At national level some of the support agencies include the Khula Enterprise Finance, the Department of Trade and Industry (DTI), the National Youth Development Agency (NYDA) Micro Loans, the Small Enterprise Development Agency (SEDA) and the Basic Entrepreneur Skill Development (BESD) Programme. At the provincial level the main support programmes are the Free State Premier's Project and the Free State Development Corporation (FDC). It should also be mentioned that most of the national agencies operate at provincial levels as well.

Findings also revealed that most of the services provided by these support structures were more at a technical rather than practical level. Many transited businesses are not familiar with these support structures. According to the findings, only two of these support structures were well-known: the FDC and SEDA. However, another important support structure not discussed earlier in Chapter 2 but which seems to play a significant support role in assisting firms in their formalization process is the Mangaung Municipality. About two respondents indicated to have to some extent made use of the Mangaung Municipality business support initiative.

### 5.3.3 FINANCIAL INSTITUTIONS

Another significant implication is that related to the role of financial institutions in supporting and enhancing foreign-owned business transition and growth in the formal sector. It would be important that financial institutions, while being cautious of potential clients who may not align to all requirements, support businesses which desire to formalize by providing customised facilities for these entrepreneurs to have access to bank accounts which could be used for business purposes.

### 5.3.4 LEVEL OF EDUCATION

Furthermore, mounting evidence that education plays a significant role in the transition of businesses from the informal sector to the formal sector was revealed. Firms that succeeded in the transition process had at least matric. The level of education of the entrepreneur or business manager thus appears to be a strong determinant in the transition to the formal sector. This finding supports an earlier argument by Van der Sluis and Van Praag (2008:15) that there is a positive correlation between the level of education and entrepreneurship performance. With the changing world economic system to a more knowledge based economy, the educational skills of entrepreneurs may have to play a major role in the establishment and success of businesses.

These educational skills are a pre-requisite for individuals in the informal sector willing to advance to a high level, more productive, innovative and performance-based economy which is the formal sector. This research thus agrees with the findings of McCulloch et al (2010:20) that strong evidence exists that better educated owners/managers are significantly and sizably more likely to formalize their businesses". Arguably, while a higher level of education does not directly imply an entrepreneur will make the transition of his/her SMMEs from informal to formal, it can in many ways facilitate the process.

### 5.3.5 ACCESS TO FINANCE

The findings of this research demonstrated that firms in the informal sector do not have access to formal finance structures. Interviews and literature on access to finance revealed that the main source of finance to firms in the informal sector is borrowing from friends, family, *tontines* or *Njangis*. Some or almost all business owners explained that they started their operations in the informal sector because of their lack of start-up capital.

Another finding which can be typical to South Africa in general and Bloemfontein in particular is that businesses formalize in order to get access to government tenders.

In conclusion, it should be mentioned as an implication that entrepreneurship education needs to be integrated in the training of young South African students from primary education way up to university education. The need for basic entrepreneurial skills remains an important aspect for business growth and expansion. For any thriving economy, the private sector remains the backbone of the economy and South Africa needs to revise its educational system so as to harness an entrepreneurial culture among young South Africans.

In summary the study revealed that while there are some important factors which affect the formalization of SMMEs, such as access to right information and relevant policies, there is no one-size-fits-all approach to understanding and facilitating the process of formalization. This is because depending on the size of the business, the gender, education levels and access to finance options of the individual entrepreneur, they will apply themselves to different strategies of formalization. Furthermore, the study showed that the process of formalization is also motivated by different factors. While some foreign-owned business may want to formalize so as to gain access to formal finance through bank loans, other entrepreneurs will want to formalize so as to get access to government tenders while others want to benefit from the support agencies.

Thus findings of similar studies have to be understood not only in the broader context of the prevailing government policies and business climate, but also at the individual contexts of different businesses or entrepreneurs.

## **5.4 RECOMMENDATIONS**

### **5.4.1 RECOMMENDATION TO THE GOVERNMENT**

One of the reasons that accounted for the significant presence and growth of firms in the informal sector as mentioned in Chapter 4 is the government's failure to meet the needs of these firms in this sector through the formal sector provision. Notwithstanding the failure of the government to meet the needs of entrepreneurs, the following are the recommendations to government based on the key findings in Chapter 4 and the conclusions and implications discussed in Sections 5.2 and 5.3 respectively above.

Though the state is critical for formalisation, this goal (formalisation) cannot be achieved by the state alone. The state must work in close collaboration with banks and active support structures such as the SEDA and FDC in the case of Mangaung. ILO (2009:26) suggests that the state must use a wide range of enforcement and regulatory techniques such as hybrid strategies, using both non-governmental and governmental strategies to assist businesses in the transition phase. The government needs to be multi-faceted, using a number of different strategies simultaneously. ILO places emphasis on the state searching more innovative forms of regulation than the dogmatic regulation commonly associated with "command and control" which may lead to unnecessary strictness. The ILO suggests three regulatory techniques which may turn out to be particularly fruitful and include the following.

The first is educating and informing people in the informal sector on formalization, providing financial subsidies to businesses in their transition phase and innovating procedural regulation to favour those in the informal sector willing to become formal (ILO, 2009:26).

The second is to promote a greater awareness of the benefits and protection that comes with formalization, creating a regulatory environment and an enabling policy that reduces the challenges faced by businesses during the process of formalization (the above regulatory techniques (ILO, 2009:33).

According to Fandl (2010:5), if the state aims to improve its growth prospects in the face of rising informality, it therefore has to be willing to reconsider how it sees informality. The state must follow a methodology that attempts to better the lives of firms or businesses in the informal sector, expand their chances to voluntarily formalize and offer basic social services like access to formal institutions and training to those that do not.

Government should reduce administrative barriers involved in the process of formalization such as long queues and the lengthy process of registration. A working website could be made available on the internet whereby people could register their companies online. This website must make provisions for applicants to be able to track the progress of their online application. Officials could also be put in place to facilitate online applications made by clients. These officials facilitating online applications will go a long way to lessen the long queues involved in the process of formalisation. The provision of online applications should mitigate long queues as applicants can complete these processes from the comfort of their offices or homes.

Another recommendation is that the government should create or establish satellite offices in all the provinces in order to ease access to its support structures such as SEDA and FDC. Some provinces do not have support structures put in place by the government to assist individuals or firms in their process of formalization which normally compel them to go to bigger provinces for registration requirements. In light of the above mentioned points, the government could work hand-in-hand with the training systems such as the Small Business Centres in all vocational training institutions.

The government should intervene in the informal sector to enable it to grow and also to promote its presence. The government can provide informal enterprises with the same kind of incentives it provides to formal firms. These incentives could be in the form of loans, government contracts and tenders, marketing and credit facilities as well as training. The above provision will either help to increase the number of businesses who formalize their activities to the formal sector or strengthen the presence and growth of informal firms. This government action will go a long way to benefit the government in the sense that it will increase the contribution of informal sector activities in the economy thereby increasing the country's Gross Domestic Product (GDP).

Lastly, the government should alleviate the financial constraints faced by business owners in their transition phase to relieve those entrepreneurs entrapped in the informal sector due to lack of start-up capital. Many interviewees reported that they started their business in the informal sector because they could not afford start-up cost. These financial constraints can be alleviated by the government working hand-in-hand with financial institutions within the country to make credit facilities available to firms/businesses in the informal sector willing to become formal.

#### 5.4.2 RECOMMENDATIONS TO THE INFORMAL SECTOR BUSINESSES

Business owners in the informal sector are advised to take initiative to access the right information pertaining to formalization of businesses. They must educate themselves on the structures instituted by the government to assist firms in the informal sector willing to become formal. These entrepreneurs in the informal sector are also advised to improve their skills and education levels. The issue of skills and education level of business owners/entrepreneurs in the informal sector can however be solved through the Sector Education and Training Authority (SETA). The SETA has been established since 2005 by the South African government to provide skills, education and training in 23 sectors of the economy including the informal sector.



### 5.4.3 AREAS FOR FURTHER RESEARCH

The limitations on this research create an opportunity for further research on the topic. A larger sample size must be used for further research in order to achieve a sample that is more representative of the entire population in South Africa.

### 5.5 RESEARCH LIMITATIONS

The lack of resources to undertake the study on a wider scale and unwillingness of some entrepreneurs to participate limited the response rate. A larger sample size could have provided better and richer data from a wider response group. This could provide more support to the emerging themes hence more nuanced findings. Geographically, limited resources (financial, time constraints) prevented the researcher from travelling across the municipality in order to get a fairer geographical distribution of respondents. Hence most of the respondents were based in the Bloemfontein area and only a few from Botshabelo and Thaba-N'chu areas. This could also limit the findings related to the geographical location of the businesses.

Another major limitation was financial constraints and the fact that some of the respondents could not express themselves fluently in English language which limited some respondents' ability to express their views freely.

Another limitation of the study is the limited access to names of employers and businesses which have made the transition from informal to formal. While some of the business support services had a database with this information, their confidentiality agreements with these enterprises could not permit them to provide such information. Hence snow-ball sampling was used, in which entrepreneurs interviewed became "resource persons" who connected the researcher to other entrepreneurs who had made the transition.

## **5.6 CONCLUDING REMARKS**

This study presented the motives, challenges and coping attributes of “graduated businesses” in the Bloemfontein area in their formalisation journey. The formalisation of enterprises remains a major challenge in most developing economies. While this endeavour is supposed to benefit the government (as businesses declare and pay taxes), the firms are supposed to benefit through better business opportunities and access to formal finance and other support services. However, there seems to be a break in communication between firms in the informal sector who want to make the transition and government support services established to support firms in the transition. This miscommunication is manifested in diverse ways including lack of information about the benefits of formalization, the process of formalization as well as the challenges facing a business in the early years after formalization. Hence there is need for more engagement between businesses in the informal sector and business support services. The study however reveals that different businesses have different motives, challenges and coping strategies once formalized. While there can be no one-size-fits-all policy to address the different needs, there is need for more such studies by academics and business support agencies themselves to be able to understand the post-formalization experience of businesses and how they can be supported to reduce the current high failure rate of SMMEs that often occurs between three and five years after establishment.

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## **ANNEXURE A: INTERVIEW GUIDE**

Good day Sir/ Madam. My name is R.E. NDJIKE TASSIN, a Masters student of Business Administration at Central University of Technology, Free State.

This study investigates the transition of businesses from the informal to the formal sector. The objective is to understand the motives to formalise, the challenges encountered by businesses in the process of formalisation and the personal coping attributes of businesses that made it through the process of formalisation in the Bloemfontein area.

All respondents' anonymity is guaranteed and data obtained from the interviews will be solely used for academic purposes. Participation in the interview is entirely voluntary.

The interview will take about 30 minutes of your time. You are kindly requested to participate in this research that is intended to assist in making the formalisation of informal businesses in South Africa much easier.

**Your co-operation is much appreciated!**

## Questions for open-ended discussion

### 1. Background Information of the business owner which will inform us who the owner is, where he/she comes from and why the Bloemfontein area.

- i) Gender \_\_\_\_\_.
- ii) What is your highest level of Education? [Probe on answer]
- iii) When did you start your business? [Probe on reasons]
- iv) When you started your business, am I correct, it was informal?
- v) What sector of business are you in? [Probe, why?]
- vi) For how long have you been operating in the informal sector [Probe on reasons]?
- vii) What probed you to register your business? (What were the reasons to formalise?)

### 2. Motivation- opportunities that most attracted the business to formalise.

- i) What were the main reasons behind your decision to formalise? [probe on reasons] (Ask this question if question 7 above has not been answered).
- ii) From which support structure did you get assistance during the process of formalisation?
- iii) Can you tell me what the reasons for formalisation are?
- iv) What is your opinion on the process of formalisation?

### 3. Challenges encountered during the process of formalisation.

- i) What were the challenges you encountered during the process of formalisation? [Probe, challenges]?
- ii) How did you overcome these challenges? [Probe on support structures, private sector and government registration].
- iii) What is your view on private sector support structures?

**4. Coping mechanisms of owners in the transition process.**

- i) If you were to advise someone in the informal sector willing to move to the formal sector, what attributes do you think this person needs in order to do so?
- ii) What personal attributes do you think someone needs to overcome the challenges of formalisation?

**5. Strategies to reduce the challenges faced during the formalisation process.**

- i) What strategies do you think could be put in place to reduce the challenges of formalising a business from the informal to the formal sector?

Final comments?

**Thanks sincerely.**