

Investigation of Factors Which Hinder SMEs' Formalization in Chilenge Market of Lusaka District

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Abstract

The aim of the study was to investigate factors which hinder SMEs' formalization in Chilenge Market of Lusaka District and research objectives were to identify factors that promote SMEs to operate in the informal economy; to analyze the competitive advantage that formal SMEs have over informal SMEs; and to find out if the legal environment supports informal SMEs' transition to the formal economy. The study employed a descriptive research design with a sample size of 595 SMEs who were operating from Chilenje Market in Lusaka. Quantitative data were collected by using the questionnaire and were analyzed by using SPSS. The study concluded that the level of education for enterprise owners; awareness of government services; awareness of government services and the procedures involved in accessing government support; cost of formalisation for registered businesses; levels of satisfaction for government services; and laws and policies on enterprise formalisation were directly linked to enterprise owner's decisions to either formalise their businesses or not. The study recommends that the government should consider offering business training for owners of SMEs for them to be able to make well informed decisions that can improve and lead to business growth. The study further recommends that the government should provide incentives to financial institutions that provide affordable credit for SMEs and start-up businesses; coming with up a communication strategy so as to improve communication of government support and services for SMEs; and proper implementation of laws and policies that that are meant to support SMEs and facilitate graduation of SMEs from informal to the formal economy.

Keywords

Formalisation, Small and Medium Enterprises, Informality, Lusaka District

1. Introduction and Background

According to Kenyon (2007: p. 3) “Formalization refers to the process whereby previously non-compliant enterprises become integrated into these formal or state sanctioned institutions, such as property registries and tax-rolls”. It is argued that formalizing of informal SMEs is key if the tax base has to be expanded by collection of revenue locally (Mutakyahwa, 2012). The assumption with this view is that informal SMEs make enough sales or revenue which if formalized would translate to significant contributions through taxation and this assumption is problematic because some SMEs are just be survivalists and the only amount of money government can get from them if they are formalized could just be registration fees paid during formalization process.

Enterprise formalization is critical for the growth of the economy as it leads to creation of formal jobs and expansion of tax base for the government as well as a strategy for poverty and inequality reduction. Formalisation is further seen to also benefit entrepreneurs as it allows them to have access to finance with lower interest rates which enables them to attract more clients and increase turnover and profits.

Informal enterprises are defined as unregistered business entities and enterprises that are not compliant to government regulations such as labour laws and payment of taxes which denies the government the much needed revenue (Maniraguha, 2020). According to Ackermann et al. (2010), an enterprise will only formalise when it reaches a certain turnover because formalisation is the only alternative for an enterprise that is growing as it becomes difficult to hide from state inspection.

From a national stand point, the informal economy presents both benefits and costs for society. On the one hand, the informal economy offers job opportunities and income in particular for the poor population and enables businesses to operate that would ordinarily not be able to operate under the formal economy because of low entry costs for starting up businesses in the informal economy (Ackermann et al., 2010). In as much as the ideal situation is to have most of the enterprises operate in the formal economy, informal economy is still beneficial as it offers low cost platform for experimentation of ideas which subsequently lead to business growth.

Assenova & Sorenson (2017) posits that informality has long term negative implications for the economy such as overall economic growth and productivity because the government is not able to provide public goods and services such as road infrastructure, education and law and order enterprises do not pay taxes due to tax evasion. As a consequence, lack of resources and of public goods negatively affects the business environment, which is not able to support small-scale enterprise development which require friendly environment to thrive. Further, employees for informal enterprises are more susceptible to abuse and do not benefit from government legally mandated benefits such as annual leave, pension, safety etc. On the other hand, formal enterprises are believed to benefit from

legitimate market for their products, access to finance, business training and more sales due to consumer confidence in the products (Assenova & Sorenson, 2017).

According to Kenyon (2007), some enterprises prefer staying informal because of costs associated with formalization such as registration fees, taxes, costly health and labour standards and perceived inadequate receipt of public services. Further, some business owners do not have motivation to formalize or comply with government regulations if their peers are not compliant and subsequently view formalization as disadvantaging themselves. In addition, collected tax revenues are not a guarantee that governments will use them effectively and efficiently to provide the public goods and services needed for business environments that support development of enterprises.

Fatoki (2014) argues that Government's legal and regulation impacts businesses significantly and determines the environment for trading which can either facilitate transition of SMEs from informal to formal or inhibit SMEs' formalization. Government regulation is believed to be necessary for the provision of trading conditions and development of trust between SMEs and the government which have the potential to encourage SMEs to formalize for easier businesses' growth that is beneficial to both SMEs' owners and the government (Fatoki, 2014). However, deregulation, over-regulation and lack of regulation are not good for business and there is therefore need for government regulations that can support formalization of informal SMEs.

Technological development is one of the key elements and prerequisites for both domestic and international competitiveness of SMEs (Maunganidze, 2013). However, investment in technology is very expensive and individual SMEs can barely afford to fund or pay for technology required improve production and delivery of goods and services. SMEs' inability to have access to technology demands that they partner and collaborate with established home and foreign businesses for them to access the much needed technology and this subsequently entails that they also formalize their operations as partnerships and collaboration cannot be established if SMEs are not registered and compliant with relevant government authorities. It is therefore very critical for SMEs to formalize if they grow and enjoy other services such as partnerships and collaborations with other established businesses institutions.

The paper investigates factors which contribute to hindrance of SMEs' formalization in Chilenge Market of Lusaka District.

2. Literature Review

One of the barriers to enterprise formalization concept is inadequate information on pros and cons of enterprise formalization. Inadequate incentives to help businesses formalize is another challenge with regard to formalization. Deliberate schemes of financing and training programmes for business enterprises have the capacity to lead to higher registrations of businesses which can translate

into more revenue and economic growth (OECD, 2020). However, caution should be exercised when giving out incentives and tax breaks as these incentives could be costly because it takes time for the government to benefit from formalization of businesses.

The level of education among informal entrepreneurs determines the likelihood of formalization. In this regard, entrepreneurs with post-secondary school education training are more likely to formalize their businesses than those without post-secondary school education (Shah, 2012). This is because entrepreneurs with higher level of education better understand the limitations and business challenges that come with informality and benefits of running formalized businesses.

A study of 11 Pakistan cities revealed contrasting findings that people running informal enterprises were better educated than people working in the formal sector because education was found to lead to higher wages in the informal sector than the formal sector (Williams & Shahid, 2013). The higher number of better educated people in Pakistan running informal enterprises was due to high taxes which make tax compliance extremely costly which make business owners remain in the informal economy just like in other countries.

A study conducted by Koto (2015) on the determinants of the decision of owners of small enterprise in Ghana to participate in the informal sector at start-up using the 2013 World Bank Enterprise survey data and binary choice models, revealed that the informal sector in Ghana was dominated by lowly educated people who did not have employable skills. People therefore, find themselves in informal economic activities as a way of survival rather than attempting to intentionally avoid compliance to formal sector regulations.

A common argument often advanced as the cause for informal enterprises is that higher tax rates lead to higher levels of informality among enterprises. However, results from cross-national comparative studies disprove this notion as in advanced economies, there is no significant relationship between tax rates and enterprise informality levels (Williams, 2014). In many developing countries, a similar assumption exists that higher tax rates make many entrepreneurs to operate under the informal sector. However, much as this assumption may be true in some cases, it may also mean that in countries where citizens have confidence in the government with regard to the usage of tax payers' money, higher tax rates do not have impact on entrepreneurs' decisions to either operate in informal or formal sector.

Some entrepreneurs find it unfair to incur the costs of compliance with government regulation by paying registration fees, paying taxes, compliant with labour laws and health and safety standards if their competitors are not compliant. Operating in the formal sector is quite costly as requires compliance to the formal economy rules which includes tax remittance, it is therefore important for firms operating in the formal economy to enjoy public services in return for their compliance and put their businesses at a competitive advantage if formalization is to be seen to be attractive to informal firms.

The ease of registering business enterprises has been argued as one of the major obstacles to enterprise formalization. Registration of business includes and involves procedures, time and payment to secure certificates from different government regulatory bodies such as tax, patents and labour department (Williams, 2014). The assumption is that easing registration of business enterprises by lowering the costs and reducing time needed by introducing a one-stop service where people can get all the services and register with all the government agencies without the need to visit various places and buildings located in different places will lead to increased formalization of enterprises.

A study by De Mel et al. (2013) in Sri Lanka however, showed that reduced costs and time of business registration or one-stop shop for registration and tax reductions did not result into more business registrations but increased enforcement led to more business registration.

One of the challenges that informal enterprises face on average is low productivity compared to their formal counterparts. Informal enterprises tend to have lower margins and often operating in saturated markets which seldom have the absorption capacity of significant compliance costs (ILO, 2021). Low productivity therefore ought to be regarded as a drive for enterprise formalization as it is also a consequence of informality.

From the government and society's stand point, untaxed informal enterprises lead to reduced tax base which consequently makes it harder to have provision of public goods and services for the citizens and creation of culture of compliance and social cohesion. From the formal workers and enterprises' point of view, informal economy leads to unfair competition from untaxed informal enterprises and informal workers. It is sufficing to state that informality is an obstacle for enterprises' growth because they can hardly access credit from financial institutions, business development services and business partnerships from other established companies as they require enterprises to meet compliance standards and formal registration such as tax registration and invoicing, decent work, etc.

One of the challenges with formalisation is that it is not a one-time process but a gradual process which involves a number of steps to be fully implemented. Informal firms that choose to register their businesses have to follow various bureaucratic procedures and benefits of operating in the formal economy do not come immediately while they are expected to pay taxes and other fees for operating in the formal sector (Mugisa, 2021). Employees in the informal enterprises also do not see benefits immediately because their labour standards and benefits need to be negotiated between the government and the employers including workers and employers' representatives (Mugisa, 2021). It should be noted therefore that the goal for formalisation is not to attempt to formalise all informal firms as this is untenable ambition because a number of firms will remain informal for quite a foreseeable future as even the most developed of nations still have some levels of informality in their economies. The aim of formalisation

therefore is to have a good number of informal firms graduate to formal firms in quest to broaden the tax base and create more formal employment opportunities and increase the benefits for operating in the formal economy.

Growth of business ventures is critical for the ultimate growth of the economy because of the potential they have to create employment and subsequently lead to improved living standards of the people. However, business ventures can only grow when they are formalized and are operating as formal business entities and this is the challenge that SMEs have in Zambia as most of them are operating in the informal economy.

Formalization is regarded to have many potential benefits for the economy such as poverty reduction, creation of bigger and stronger economies with improved goods and services. Formalisation of informal businesses is important for governments as it is a strategy for economic development and poverty reduction (Benjamin et al., 2014). On the other hand, formalisation also benefits business owners far much beyond mere acquiring of licenses to operate in the formal sector but enables them to potentially have commercial contracts, membership in trade associations, legal ownership of their places of business and increase their productivity, enjoy tax breaks and incentive packages to increase their competitiveness, protection against creditors and clear bankruptcy rules, and social protection (Mugisa, 2021).

According to the ILO (2014) there is a distinction between formalizing enterprises and formalizing employment and this distinction should be taken into account when devising strategies for formalization so as to ensure that policy makers are aware that policies designed to facilitate enterprise registration do not always lead to formal employment and compliance with labour laws.

The other strategy for enterprise formalization is by getting rid of inappropriate taxation systems which have been found to encourage informality. Many enterprises fail to comply with the tax system because it is too complex, expensive and opaque. In many cases, enterprises are simply not aware of their tax obligations or fearful of the tax system. A desire to avoid tax is often at the heart of the decision to not register or obtain the necessary licenses. Tax compliance can be eased by introducing more transparent and simplified tax reporting requirements, improving tax inspections, reducing the number of payments, offering different payment options, and differentiating tax schemes for SMEs.

3. Methodology

The study adopted the descriptive research design to investigate factors which contribute to hindrance of SMEs' formalization. The target population for the study comprised of 595 SMEs based in Chilenje Market in Lusaka. The random sampling technique was employed and the sample size was arrived at through the use of Taro Yamane's formula which is calculated as follows:

$$n = N / 1 + N(e)^2$$

where; n = the required sample size, N = the number of SMEs in Chilenje Mar-

ket and e = permissible error (%). When we substitute numbers in this formula, we arrive at:

$$n = 595 / (1 + 595(0.05)^2) = 239$$

The researcher distributed a total of 239 questionnaires to SMEs in Chilenje Market out of which 187 representing 78% were received for analysis. Data analysis was done by using SPSS software through which descriptive and correlation analysis done test the effects on various factors on enterprise formalisation among SMEs in Chilenje Market in Lusaka, Zambia.

Research Questions

The researcher used the following research questions:

- 1) What factors promote SMEs to operate in the informal economy?
- 2) Do formal SMEs have competitive advantage over informal SMEs?
- 3) Does the legal environment support informal SMEs' transition into the formal economy?

4. Results

Educational Level of Respondents

The researcher sought to evaluate the level of education for respondents according to the Zambian Education System as indicated in **Table 1**.

4.3% of respondents had bachelors' degrees, 17.6% indicated they diplomas, 8.6% had college certificates, 57.8% had grade twelve (12) certificates, 10.7% reported that they had grade nine (9) level of education, and 1.1% had grade seven (7) level of education. The results entail that majority of respondents may not have good understanding on the pros and cons of enterprise formalisation.

Registration of SMEs with PACRA and ZRA

The researcher also sought to find out the number of enterprises that were registered with ZRA and PACRA against unregistered ones and found the following results as indicated below in **Figure 1**:

Figure 1 revealed that 33% of enterprises were registered with PACRA and ZRA while 67% were not registered with PACRA and ZRA.

Why SMEs are not Registered with PACRA and ZRA

Reasons for staying informal among unregistered enterprises with PACRA and ZRA were sought by the researcher and results were revealed as indicated in **Figure 2**.

Figure 2 indicates that 24.6% of respondents were not registered with PACRA and ZRA because owners did not know the procedure for registration; 11.8% were not registered because owners thought it was expensive to register their businesses representing; 26.7% of business owners thought their businesses were too small to be paying taxes representing and did not register them as a result; and 5.3% that that registering their businesses was time consuming to register.

Respondents' Perception on Registration of Businesses with PACRA and ZRA

Table 1. Respondents' levels of education.

Level of education	Frequency	Percent	Cumulative Percent
Bachelors	8	4.3	4.3
Diploma	33	17.6	21.9
College Certificate	16	8.6	30.5
Grade 12	108	57.8	88.2
Grade 9	20	10.7	98.9
Grade 7	2	1.1	100.0
Total	187	100.0	

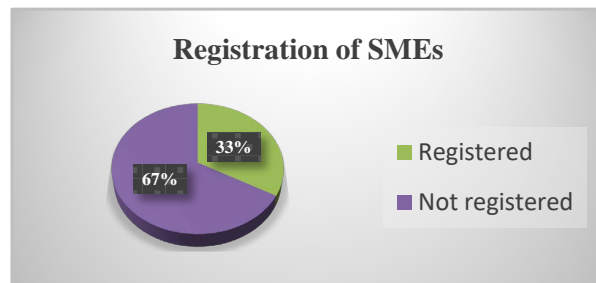


Figure 1. Registration of SMEs.

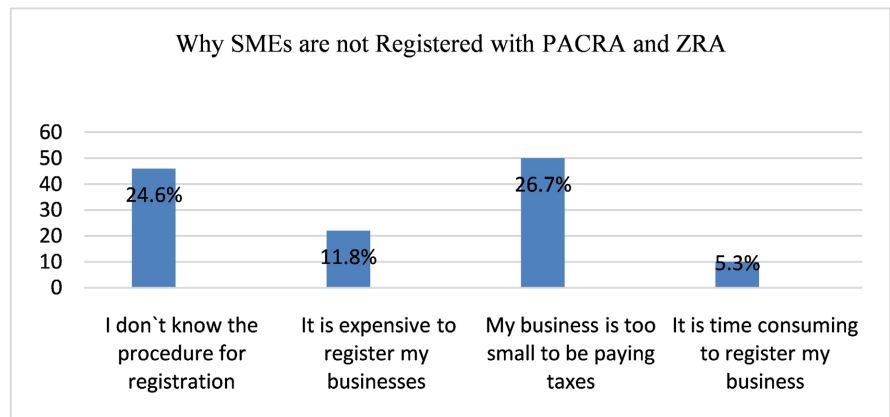


Figure 2. Reasons for nonregistration of SMEs with PACRA and ZRA.

The researcher sought to understand respondents' views on whether they thought it was beneficial to register their businesses with PACRA and ZRA or not. Results as indicated in **Figure 3** showed that 50.3% of respondents were of the view that it was beneficial to have enterprises registered while 49.7% thought that it was not beneficial to register their businesses. Results indicated that most respondents understood the benefits of formalizing their businesses despite that their businesses were not registered.

Business Loan

The researcher sought to understand if access to finance had an effect on enterprise formalisation and the results as indicated in **Figure 4** showed that 55.4%



Figure 3. Benefits of business registration.

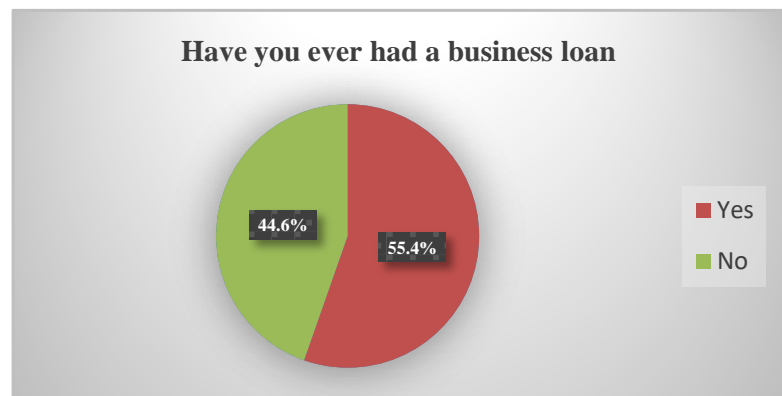


Figure 4. Business loan.

respondents indicated that they had at one point had access to credit for their businesses while 44.6% never had access to credit for their businesses.

The researcher further sought to find out the source of finance for enterprises that had accessed it and results as indicated in **Figure 5** showed that 8.7% of respondents got their loans from banks, 31.1% got their loans from micro-financial institutions, 4.9% got their loans from Loan sharks (Kaloba), 44.7% got their loans from village banking, and 10.7% got their loans from friends and relatives.

Business Training

The researcher asked respondents to indicate whether they had received training in business or not and results are presented below in **Figure 6**.

Figure 6 shows 26.2% had received training in business while 73.8% of respondents had received training in business which could be the reason for a higher percentage of unregistered enterprises.

Satisfaction with Government Services (i.e. condition of the market)

Study participants were asked to indicate whether they were thought Government services were worth paying taxes for and results as indicated in **Figure 7** showed that 60% were not satisfied with Government services and did not think they were worth paying taxes for while 40% were satisfied with government services and thought that they were worth paying taxes for.

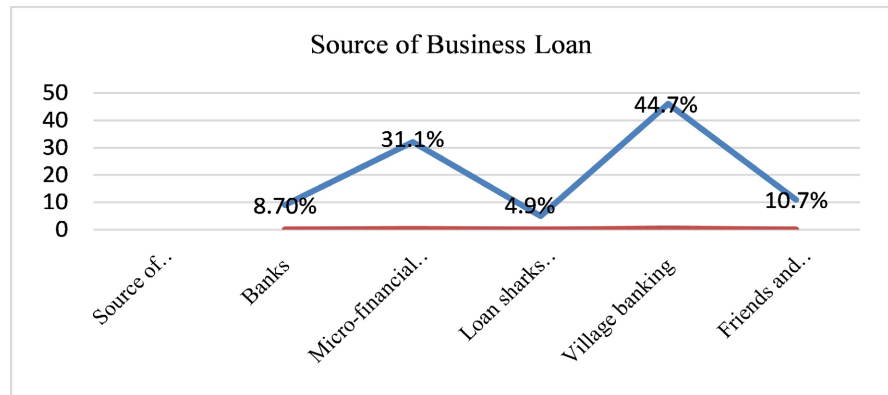


Figure 5. Source of business loan.

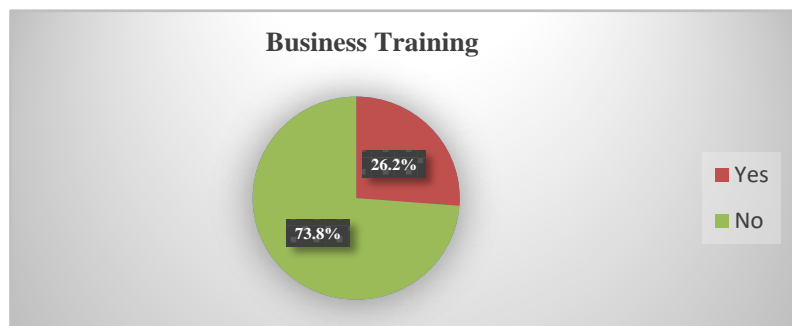


Figure 6. Business training.

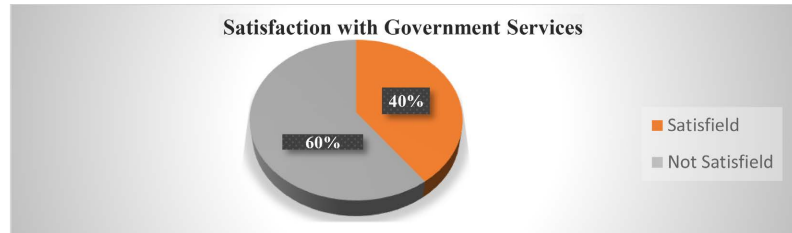


Figure 7. Satisfaction with government services.

Respondents' Awareness of Government's Support for SMEs

The researcher sought to find out if respondents were aware of the support for their businesses they could get from government and results as presented in **Figure 8** revealed that 49% were aware of government support for SMEs, while 51% were not aware government support for SMEs.

Business Support Required by Respondents

Respondents were asked to state the type of support they needed for their businesses and the results are shown in **Figure 9** revealed that 4.8% indicated that they needed support with regard to business registration with PACRA; 2.1% indicated that they need support with business registration with ZRA; 3.2% indicated that they needed support with regard to tax returns; 26.2% indicated that they needed loan with lower interest rates; and 0.5% indicated that they needed tax holidays for small Zambian businesses.

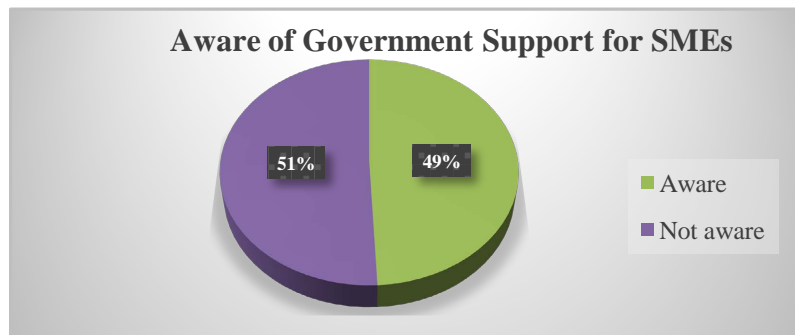


Figure 8. Government support for SMEs.

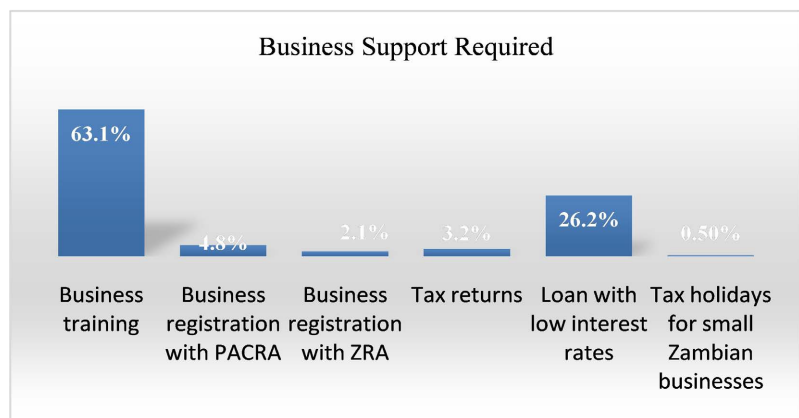


Figure 9. Business support.

Government's Efforts in Supporting SMEs

Respondents were asked if they thought the Government was doing enough with regard to supporting SMEs and results as indicated in **Figure 10**, showed that 12.8% were of the view that the government was doing more than enough, 69.0% were of the view that the government was doing well but needed to improve, and 18.2% were of the view that the government was not doing well.

5. Conclusion and Recommendations

The research concluded that formalisation of SMEs in Chilenje Market is associated with the level of education for enterprise owners, enterprise owners' awareness of government services, cost of formalisation, and levels of satisfaction for government services and laws and policies on enterprise formalisation which contributed or had an effect on business owners' decisions to either formalise their enterprises or not.

The study made the following recommendations:

- 1) Consider offering business training for owners of SMEs for them to be able to make well informed decisions that can improve and lead to business growth.
- 2) The current interest rates on credit are too high for SMEs or start-up businesses, the government should therefore provide incentives to financial institutions that provide affordable credit for SMEs and start-up businesses.

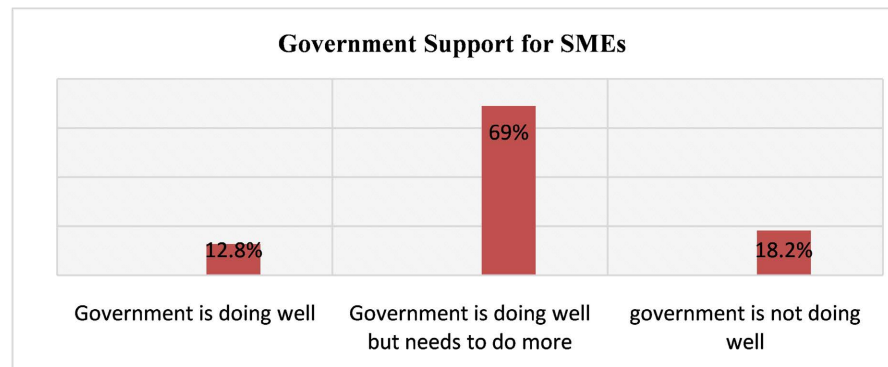


Figure 10. Government support for SMEs.

3) Financial institutions should come up with innovative and less risky ways through which they can provide loans to SMEs with relaxed collateral conditions.

4) Government to come up a communication strategy to improve communication of government support and services for SMEs.

Conflicts of Interest

The authors declare no conflicts of interest regarding the publication of this paper.

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