

Formal and Informal Microenterprises

Jessica Leino

This note uses unique data from enterprise surveys in three African countries to examine the characteristics of informal and formal microenterprises. Entrepreneurs in the informal sector have different motivations for starting a business from their formal sector counterparts, with about twice as many informal entrepreneurs citing lack of alternative employment opportunities as their main motivation. Female entrepreneurs are more likely to operate in the informal sector, with 38 percent of informal businesses and only a quarter of formal businesses owned by women. Differences in entrepreneur characteristics translate into differences in business practices, with informal firms less than half as likely to have paid employees and nearly half as likely to have bank accounts.

The informal or unregistered sector constitutes a significant proportion of the economy and employs a majority of non-agricultural workers in many developing countries, especially in Africa. Many facets of the sector, including why firms remain informal (e.g., Gelb et al. 2009), the role regulation plays in informality (e.g., Djankov et al. 2002), and the productivity of the informal sector (e.g., McKenzie and Woodruff 2008), have been studied in various contexts and remain hotly debated. This note uses a unique new survey of the informal sector done in conjunction with the main Enterprise Surveys¹ in three African countries to examine the characteristics of informal firms and explore how the constraints they face differ from businesses in the formal sector. The informal firms were selected to mirror the sample of registered microfirms² surveyed, so it is possible to directly compare firms operating in the formal and informal sectors in Côte d'Ivoire, Madagascar, and Mauritius.³

The three sub-Saharan African countries examined in this note reflect a broad spectrum of business environments. According to the *Doing Business 2009* Report, Mauritius ranks 7th (out of 181) in the world for starting a formally registered business, Madagascar ranks 58th, and Côte

d'Ivoire ranks 167th. The approximately 600 formal and informal microfirms that were surveyed represent a variety of business activities, including food production, garment and textile manufacturing, other manufacturing, retail and wholesale trade, and other services. Almost all business activities are represented in both the formal and informal sectors, and most activities do not seem to be restricted to either the formal or informal sectors. The composition of firms in the survey sample differs from country to country, but retail and wholesale trade is always the most common.

What Are the Characteristics of Entrepreneurs in the Formal and Informal Sectors?

Formal sector entrepreneurs were significantly more likely to say that they were interested in taking advantage of business opportunities as the reason they started their businesses. In contrast, as shown in figure 1, informal sector entrepreneurs were more likely to cite the lack of alternative jobs. However, in Côte d'Ivoire, there appear to be more entrepreneurs of necessity in both the formal and informal sectors: the proportion of business owners citing business opportunities is lower, the proportion citing the lack of al-

ternative employment is higher, and the difference between the formal and informal sectors is relatively smaller.

Entrepreneurs in the formal sector also have more education and experience than entrepreneurs in the informal sector. While 73 percent of all formal sector entrepreneurs surveyed have secondary or university-level training, only 54 percent of informal sector entrepreneurs do. The numbers vary slightly by country, but the pattern is consistent, and the differences are statistically significant, even after accounting for differences in business activities. Formal sector entrepreneurs have 13.2 years of experience on average, while informal entrepreneurs have two years less experience, though the difference is not statistically significant.

Female ownership rates are higher in the informal sector than in the formal sector in all three countries, although women entrepreneurs always represent less than half of the sample. Figure 2 shows that in Mauritius the gap in female ownership is significantly smaller between the formal and informal sectors which, in the context of recent reforms that have made it much less costly to start a formal sector business, may provide suggestive evidence that women are disproportionately impacted by improved access to the formal sector.

The pattern of higher female participation in ownership in the informal sector holds true for firms in each business activity category, with the exception of chemical, metals, and electronics (where the number of firms is relatively small). Women tend to be concentrated in business activities such as retail trade and food and garment production. The substantial differences in the choice of sector and of business activity between male and female entrepreneurs may suggest

that access to finance or other issues constrain some entrepreneurs' ability to enter the formal sector or alter their decisions over which sector to enter, perhaps directing more women to activities with lower capital requirements.

What Are the Characteristics of Formal and Informal Businesses?

Differences in the characteristics of formal and informal firms appear to be correlated with the ease and relative expense of starting a formal sector business and may change over time as countries' policies improve. In Mauritius, informal businesses are about five years

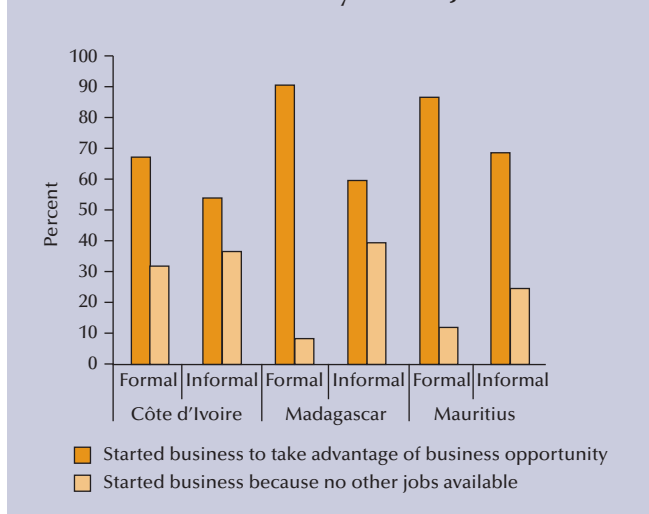
older, on average, than formal businesses, which suggests that new firms are choosing to enter the formal sector. In contrast, businesses in Côte d'Ivoire in both the informal and formal sectors have roughly the same distribution of ages, and in Madagascar formal sector businesses are more than seven years older than informal businesses. In Mauritius, 75 percent of formal sector businesses are registered at startup, whereas in Côte d'Ivoire, where it is much more

difficult to register a business, only 43 percent of formal sector businesses were registered at the time the business was created.

Informal firms also tend to start out and stay smaller than formal firms. In both Madagascar and Mauritius, informal businesses start with about 1.8 workers versus an average of 2.4 workers in formal businesses. In Côte d'Ivoire, the number of full-time workers at startup is around 2.4 in both formal and informal businesses. Formal businesses tend to have more paid employees, while informal businesses have more

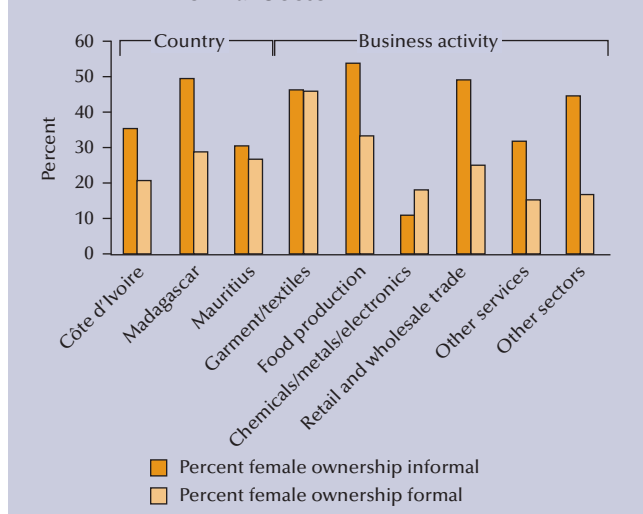
In the informal sector entrepreneurs cite the lack of alternative job opportunities as the main reason for starting their businesses.

Figure 1 Informal Entrepreneurs Motivated to Start Business by Lack of Jobs



Source: Enterprise Surveys.

Figure 2 Female Ownership Rates Higher in Informal Sector



Source: Enterprise Surveys.

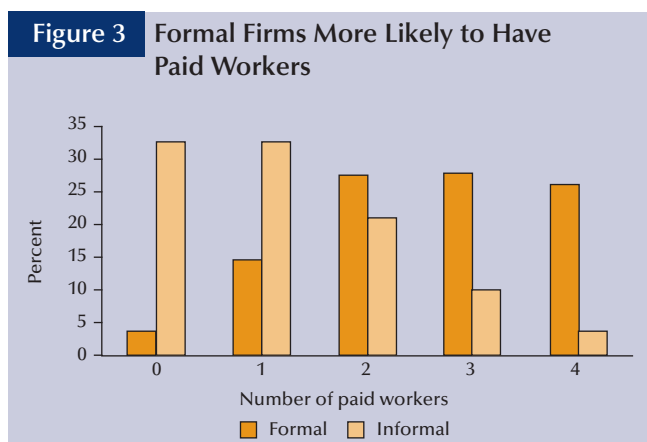
unpaid workers. In informal businesses, as shown in figure 3, the number of paid workers tends to remain low: 65 percent of informal businesses currently report zero or one paid worker.⁴ Formal sector businesses, in contrast, seem to be on a growth trajectory, with the current number of paid workers higher on average than the number of workers at start-up. Indeed, older formal sector businesses have significantly more paid employees than younger formal firms.

Employment of family members varies widely across sectors and countries. Informal businesses in Côte d'Ivoire are more likely to employ family members, with 36 percent of informal businesses but only 21 percent of formal businesses employing at least one family member. However, in Madagascar, 26-27 percent of both informal and formal businesses employ family members, and in Mauritius 39 percent of informal firms and 44 percent of formal firms employ family members. Family members were paid employees approximately 57 percent of the time that they worked in formal or informal businesses.

Formal businesses in all three countries were more likely to have permanent locations and to own their premises. Approximately 96 percent of formal sector businesses in Mauritius and Madagascar have a fixed, permanent location, as do 75 percent of formal businesses in Côte d'Ivoire. However, only between 47 percent and 63 percent of all informal businesses have a permanent business location.

How Do Formal and Informal Firms Finance Their Businesses?

There are significant overall differences between formal and informal entrepreneurs' use of external business finance, especially of basic financial tools like bank accounts. There are also significant differences in loan use and other less common forms of financing for microenterprises. While 70 percent of formally registered microentrepreneurs use a bank account for their business, only 38 percent of entrepreneurs in the informal sector do. The percentage of en-



Source: Enterprise Surveys.

trepreneurs that currently have loans for their businesses nearly doubles from 7 percent in the informal sector to 13 percent in the formal sector.

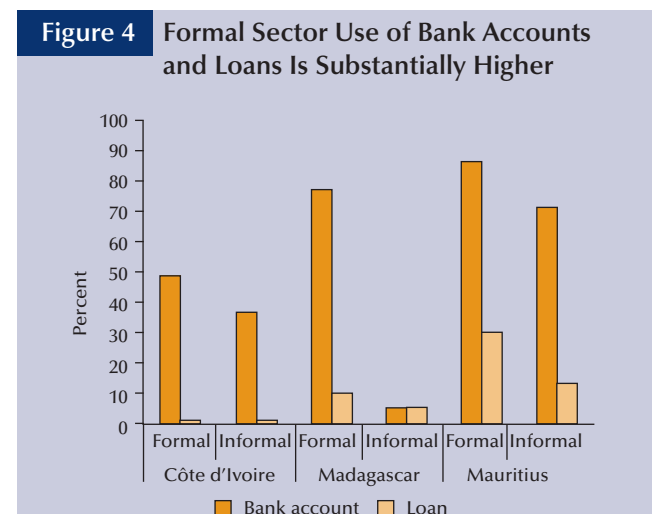
The magnitudes of external financing differ substantially across the three surveyed countries, although the differences between the formal and informal sectors are reasonably consistent. As shown in figure 4, the use of loans is much more common in Mauritius (which had the highest *Doing Business* credit ranking of the three countries surveyed in 2009), though formal sector entrepreneurs are still more than twice as likely to have a loan as informal entrepreneurs. In Madagascar, the difference between the formal and informal sectors in having a bank account is extremely large. In Côte d'Ivoire, the country with the lowest *Doing Business* rankings of those surveyed, use of both bank accounts and loans is relatively low even in the formal sector.

Why Do Businesses Remain Informal?

The main reason informal firms cite for remaining unregistered varies by country, but the top reasons are the taxes on registered businesses (46 percent in Mauritius and 31 percent in Madagascar) and getting information on how to register (55 percent in Côte d'Ivoire). As shown in figure 5, the fees

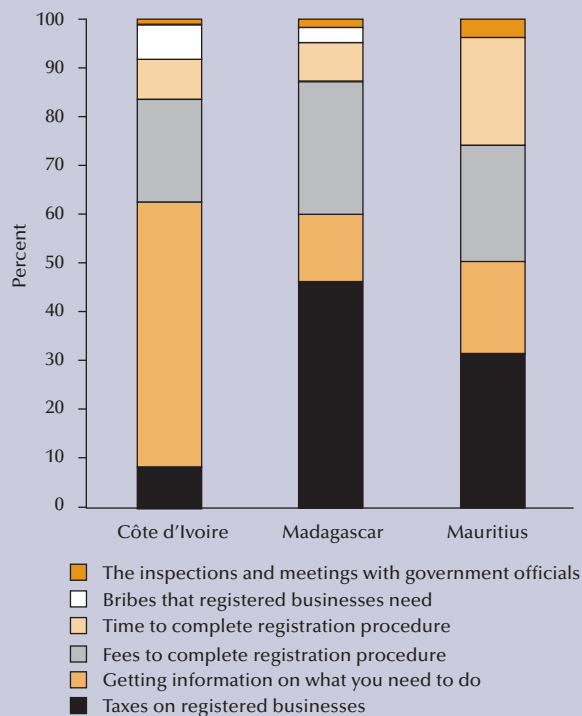
to complete the registration process are another reason frequently cited in all three countries (24 percent in Mauritius, 27 percent in Madagascar, and 21 percent in Côte d'Ivoire). Interestingly, both the time and the cost of registering a business in Mauritius are very low (*Doing Business 2009*), so these responses may reflect a lack of information about registration procedures.

Payments to remain informal are not commonly reported. In Côte d'Ivoire, nearly 6 percent of informal firms report that they are required to make informal payments in order to stay unregistered, whereas only 0.8 percent of firms in Madagascar and no firms in Mauritius report such payments.



Source: Enterprise Surveys.

Figure 5 Informal Firms Cite Taxes, Information as the Main Reasons for Remaining Unregistered



Source: Enterprise Surveys.

Entrepreneurs running formal and informal businesses in Côte d'Ivoire, Madagascar, and Mauritius have very different profiles. Entrepreneurs in the informal sector are more likely to start their businesses because of lack of alternative employment opportunities and are less educated on average. Informal sector entrepreneurs employ fewer workers, are less likely to have permanent premises, and use less business financing than their formal sector counterparts.

The greater use of financing instruments in the formal sector suggests that it may be easier to access business fi-

ancing in the formal sector, all else being equal. Formal sector entrepreneurs may also require more financing because their business needs as well as their desire to grow their enterprises are different. Additionally, entrepreneurs in the formal sector may be better able to take advantage of financing opportunities if they are more educated or more experienced.

Differences in entrepreneur characteristics likely account for many of the differences in business practices between the formal and informal sectors in the three countries covered. Policies encouraging business formalization may not be fully successful in fostering business growth if they do not recognize the different motivations and characteristics of entrepreneurs who choose to operate in the informal sector.

Notes

1. The data for Enterprise Surveys are available at www.enterprisesurveys.org.
2. Microfirms are firms with fewer than five employees.
3. However, because there is no sample frame available for informal firms, it is not possible to make inferences about the population of informal firms using these data.
4. The business owner may not be counted as paid, if he or she does not draw a fixed salary.

References

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