

THE VOLUNTARY FORMALIZATION OF ENTERPRISES IN A DEVELOPING ECONOMY—THE CASE OF TANZANIA

EDWIN G. NELSON^{1*} and ERIK J. DE BRUIJN²

¹*Associate of Durham University Business School, Small Business Centre, Durham, UK, TSM Business School, Enschede, The Netherlands and University of Dar es Salaam Entrepreneurship Centre*

²*University of Twente, Enschede, The Netherlands*

Abstract: The informal sector of the Tanzanian economy is a changing, heterogeneous mixture of enterprises operating wholly or partially outside of the government system of regulation. It flourishes partly because informality offers opportunities of economic necessity to the poor, most of who will never be able to assimilate the costs of formalization, and partly because it offers others a low cost arena for experimentation that can lead to business growth. Some enterprises do formalise voluntarily, the stimulus for which can be represented as an economic function determined by the values that operators assign to institutional incentives, opportunity costs and formalization costs, and the process can be represented as an exchange transaction with government. Government tolerates the informal sector because it reduces unemployment and contributes to poverty alleviation, but it is not officially recognized and government is under some pressure to formalize it. A policy based on formalization seen as a voluntary transaction between operators and government could focus on mutual benefits and reduce the risk of damaging fragile enterprises and livelihoods for little benefit. Copyright © 2005 John Wiley & Sons, Ltd.

1 INTRODUCTION

1.1 Informalization of Developing Economies

As the numbers of new entrants to labour markets in developing countries have grown and exceeded the numbers of jobs created in formal sectors of economy, the numbers of informal enterprises have also grown rapidly and are frequently the main source of employment. This informalization of the economy produces qualified benefits, on the one hand it helps to alleviate unemployment and poverty; on the other, however, informal jobs

*Correspondence to: E. G. Nelson, Durham University Business School, Small Business Centre, Durham, UK.
E-mail: nelson20202@yahoo.co.uk

are often of low quality and may not constitute 'decent work' in terms understood by the International Labour Organization (ILO, 2002, p. 2). Informal enterprises operate outside of the government system of regulation, which restricts government's ability to incorporate them in policies and strategies in pursuit of national socio-economic goals. Notwithstanding that informal enterprises contribute to gross national product and poverty alleviation, increasing informal development represents a widening gap between operators and government and limits the scope for a mutually beneficial government-private sector partnership—the failure of informal operators to comply with regulations that protect employment, the environment and consumers lowers the ceiling on the quality of their development and on their potential for growth and wealth accumulation. Overall, increasing informalization is an indication of the failure of government to offer a formal environment conducive to small-scale enterprise development and, since informal enterprises operate largely outside the influence of government, the increasing stake of informal enterprises in the economy limits the efforts of international institutions and donors.

1.2 Manifestations of Institutional Failure

Institutional failure can be defined as the inability of institutions to facilitate the voluntary graduation of informal enterprises (those with development potential) into the formal sector; an institution in this context being a set of constraints (norms or rules of behaviour) that influence and structure the strategies and decisions of operators of enterprises (North, 1990). Institutions can be either informal or formal. Informal institutions are those that evolve from custom and practice as uncodified norms of behaviour and obligations, which are generally maintained by peer pressure. The dominant formal institution is the legislative and regulatory environment created by government. The rules that determine the access of informal enterprises to bank capital and credit services constitute a quasi-formal institution, comprising rules generally applied by organizations subject to government regulation. The informal sector is a population of informal operators who, by custom and practice, have evolved a negative attitude towards formal government regulations, which is partially tolerated by governments cautious about exacerbating poverty or who are short of the resources necessary to enforce regulations. In this sense, the informal sector has evolved an informal institution of quasi-permitted rules of conduct in response to failures of formal institutions. Institutional failures are manifest in the complaints of informal enterprises or their advocates that they have no property rights assured by government, and little or no access to resources needed for enterprise development, such as investment capital, credit for working capital, technology and skills, land and premises and training in entrepreneurship. This may be due, for example to legislation that denies rights of ownership to land, or to banking practices that refuse to recognise the value of informal wealth and assets as potential collateral offered by operators in support of loans, or government and donor policies that deny informal operators access to subsidised business counselling and entrepreneurship training they cannot otherwise afford. In broad terms, institutional failure is manifested as an environment that is not conducive to investment in the formalization of informal enterprises. The possible causes are diffuse, but typically may include: legislation and regulatory systems that have been designed for the control of a relatively small number of larger state enterprises and are not adapted to the much more numerous population and capacities of small-scale enterprises;

administrative cultures that have evolved to interact with strong professional managers and their political patrons rather than powerless, independent, and often uneducated small operators; public officials who use their position for illicit personal benefit and prey on small-scale operators. This is the context in which formalization takes place.

1.3 Informal Enterprises

Antecedent literature indicates three principal research perspectives with regard to informal enterprises. The first is socio-economic and is concerned largely with defining and characterizing the informal sector, identifying the resources it attracts (capital, labour, technology) the markets it seeks to exploit, and the attributes of informal operators. Common descriptors used to distinguish informal enterprises from others are: ease of entry into markets, reliance on indigenous resources, family ownership, small-scale operations, skills acquired outside the formal school system, unregulated and competitive markets, labour intensive, and using adopted technology; informal operators repair and design their own equipment, business is run from home or nearby premises, they train their labour force themselves, they find start-up finance from their own savings or close relatives or from profits, they regard government agencies with suspicion, they participate in all of the activities of the firm, they are unwilling to delegate, they do not welcome outside interventions, they have a strong perception of their problems and they accept assistance only for solutions to specific problems (ILO, 1972; RSIE, 1988). Most are micro sized, having up to five employees and, in developing countries, many operate at or around subsistence level, meaning that they generate meagre, if any, surplus for their owners. In addition to institutional obstacles, therefore, formalization and growth may be frustrated by internal characteristics and capacities. However, the informal sector is heterogeneous and not all informal enterprises exhibit the same characteristics (Castels and Portes, 1991), some do have entrepreneurial owners and do have the potential to grow and formalise.

A second perspective is behavioural, concerned with motives, decisions and the success of business strategies—success being variously defined in terms of survival and growth. In a multi-country study in sub-Saharan Africa, links have been noted between entrepreneurial success and the personal action strategies of operators—proactive behaviour in planning and development being more likely to lead to success than reactive responses to unanticipated events (Frese, 2000). In a Tanzanian study designed to understand the underlying causes of growth, an expected link between positive growth motivation and actual growth was detected, but the study failed to establish links between motivation and other descriptors of the operator-enterprise entity, and the researcher concludes that other active factors must therefore be external influences (Olomi, 2001). Also in Tanzania, a relationship has been established in some small-scale enterprises between growth and operators' tendencies to innovate, also subject to external factors (Mahemba and De Bruijn, 2003). These studies tend to reinforce the notion of institutional factors in enterprise development and formalization. Interest in entrepreneurship as a factor and/or process in business success falls into this behavioural perspective, but the wide heterogeneity of enterprises, the huge variety of enterprise contexts and situations, and the complexity of operator behaviour combine to make common principles of entrepreneurship as difficult to find in Africa (Spring and McDade 1998, pp. 1–34) as it is elsewhere, leading to the possible conclusion that it is the outcome of individual learning processes (Deakins, 1996).

A third research perspective, which can be described as institutionalist, is concerned with the effect of the institutional environment on business operators—institutional constraints are a source of business transaction costs (North, 1990) and government institutions (represented by legislation, regulations and administrative culture) tend to increase transaction costs (Ferrand, 1999). In Tanzania, the capacity of government to impose regulatory constraints on informal sector activity has been observed to be limited (Trip, 1997; Heilman, 1998) and the primary effect of government is to place legal status beyond the reach of large numbers of small-scale enterprises, thus confining them to the informal sector. Institutionalists have shown that whilst being a low-cost refuge, the informal sector denies operators the benefit of growth opportunities; formal institutions do not recognise the forms in which informal operators accumulate capital and may not even recognise their existence officially, thereby denying them access to factors such as capital, technology, training and opportunities (De Soto, 2000). As a result, those operators who enter the informal sector tend to be trapped there, if not by their personal lack of growth orientation or entrepreneurship then because of institutional barriers and the costs of leaving. Some do succeed in overcoming the barriers, but there is little if any antecedent research focused on them (Harrison, 2000, pp. 139–148).

2 RESEARCH APPROACH

2.1 Research Issues

This research focuses on the formalization process in Tanzania, where much of the formal sector is downsizing whilst the informal sector grows with its demographic profile enhanced by redundant employees from the formal sector and graduates from high schools and universities. Indigenous commentators advocate deregulation and lower taxes to facilitate informal enterprise development and formalization, but there are counter-vailing considerations. For example, if government removes regulatory barriers, how will the interests of consumers, employees and the environment be protected? If taxes are reduced, how will government fund the development of physical infrastructure, social capital and services, and the institutional framework? Government has produced an SME development policy that makes no distinction between formal and informal enterprises, which reduces the likelihood of any specific focus on informal sector issues. Despite the barriers, some informal operators do break cover and formalise voluntarily and survive, which raises questions about what factors influence them to do so, and how they cope with the costs of formalization; such questions are not generally addressed by the research community.

2.2 Research Design and Data

The research focuses mainly on the process of formalization observed from the perspective of owner-managers of informal enterprises, the research vehicle being a conceptual model of the transition process within the institutional environment. Preliminary field observations identified a small number of enterprises that, starting informally, had reached different stages of formalization, whose operators could therefore provide first-hand knowledge of the process. To capture their experiences, a phenomenological, case

Table 1. Graduates from the informal sector

Operator	Enterprise activity
1. Milly Zukkia	Informal cross-border smuggling enterprise, progressing to a registered export-import business.
2. Barnabus Kemba	Experimentation with informal irrigation, retailing and carpentry, progressing to a carpentry and materials wholesale company.
3. Richard Matsu	Informal soap production, progressing to a chemical processing company.
4. Alan Mungo	Experimentation with informal wine production, insurance agency, clothes shop, progressing to wine production and safari tour companies.
5. Dan Himba	Series of informal part-time activities leading to wholly owned computer company and joint venture financial service companies.

study-based approach was adopted that would facilitate analytical generalisations from cases to theory (Yin, 1994), tracing the history of development of operators and their interactions with the institutional context. Table 1 refers to five cases in which owner-managers have progressed from the informal sector to the formal sector. The owner-managers started informally at different stages in their lives and for different reasons, but generally to generate more income—for example, Milly Zukkia left college for health reasons and after her recovery took up smuggling as her only means of support, and Dan Himba left his employment as an experienced aviation flight controller when the value of public sector wages fell below an acceptable level in the 1980s. None received any entrepreneurship education or training before or after formalizing.

3 FORMALIZATION—THE CONCEPTUAL FRAMEWORK

3.1 Key Definitions

In order to maintain some degree of invisibility from regulatory authorities informal enterprises are generally of micro dimensions, a size band that includes a high proportion of enterprises. A small proportion of them are illicit, manufacturing or dealing in contraband substances, or engaged in other activities proscribed by law, as opposed to those that are licit but informal and for which there are formal counterparts. In Tanzania, small enterprises are able to obtain local authority operating licences, for which licensing procedures are simpler and the costs lower; this confers on them a semi-formal legal status without the necessity of registration with state authorities. As the minimum compliance with regulations, all enterprises are required to have at least a local authority operating licence. When informal enterprises ‘choose’ to comply they do so in the knowledge of penalties for non-compliance, which is deemed to be a ‘quasi-voluntary’ decision (Levi and Sherman, 1997). ‘Formalization’ means graduating from the informal to the formal sector, either directly or via semi-formal status. The formal sector comprises enterprises registered with the state’s Business Registration and Licensing Authority as a business name or as a company. ‘Voluntary’ formalization is deemed to result from decisions taken without the pressure of government enforcement activities. ‘Non-voluntary’ formalization is defined as that which is coerced. ‘Involuntary’ formalization is instinctive, without conscious thought, as when operators act under a cultural compulsion to comply with the law.

Table 2. A typology of forms of enterprise in Tanzania

Formal status	Legal form	Description and subcategories
Illicit	None	An enterprise is illicit when there is no legally permitted licensed or registered counterpart
Informal	None	An activity (for which there is a formal counterpart) that does not comply with requirements of the regulatory system regarding licences, permits, certificates, notification or registration of the activity is licit but informal.
Semi-formal	Local authority licensed enterprise	An activity carried on by an operator who appears on a local authority list of licensed operators of enterprises but is not registered with the state registrar is semi-formal. For example, two forms exist in Tanzania: i. Hawkers licence, ii. Business licence
Formal	State registered enterprise	Person(s) registered to conduct business activities under a registered business name; for example, enumerated on a state register as a sole ownership enterprise, a private limited company, or a joint stock company open to public subscription shareholdings

3.2 Formalization Processes

Informal, semi-formal and formal status under the law provides a basis for an unambiguous typology of enterprises and a 'de jure' process of formalization (Table 2) proceeding in two main steps from informal to semi-formal and then to formal status. Additional steps are possible within both semi-formal and formal status bands. Each step takes the form of a bureaucratic event that changes the legal status of an enterprise. To each level of legal status there is attached a different package of obligations designed to protect consumers, employees and the environment, and to raise public revenue. The burden of obligations becomes heavier with higher legal status. A second formalization progression can be observed as a continuum comprising many progressive acts of compliance with obligations to government and with the norms of doing business in the formal sector; the term used for this being 'de facto' formalization. Whereas *de jure* formalization is a change of legal form, *de facto* formalization frequently represents a change of substance concerning behaviour and systems. *De jure* graduation and the *de facto* continuum can be separate or parallel progressions.

3.3 Formalization Mechanisms

De jure change to a higher legal form is an acceptance of a government offer of formalization, implying an agreement of terms between the two parties (operator and government), in which the operator gains recognition, the right to operate freely and property rights in exchange for the payment of taxes and submission to government regulation. This perception of formalization as an exchange transaction places it within the context of the theory of new institutional economics and raises to prominence the issue of the transaction costs, incentives and benefits. With co-operation and efficient coordination of their actions, the parties to a transaction can in principle maximize the aggregate benefits they realize from it (a win-win outcome). Conversely, by competing to maximize their self-interests, it is possible that they would minimize their aggregate benefits (a

lose–lose outcome). The choice that each makes is dependent on the clarity and acceptability of the terms of the transaction, and whether there are mechanisms for reaching prior agreement on them. In the circumstances of a formalization transaction, there is ordinarily no mechanism that enables an operator to negotiate directly with government. Any such negotiation would be conducted by intermediaries, such as representative associations and advocates, bargaining on behalf of the collective membership, the bargaining mechanism being subject to the relative power of the parties (Knight, 2001). The asymmetrical distribution of power between the parties means that superior government power prevails at the cost of operators, leaving them to cope in their own ways with the consequences of their formalization.

3.4 Institutional Structuring

In the cases studied, operators grew up in a culture of daily life supported by minimal infrastructure and barely touched by the institutions of government. The dominant influences in their formative years were family and local community and cultures, and informal enterprises. The family and community context, both of them informal institutions, condone and support informal enterprise activities; non-government organizations, including some micro credit organizations and others offering basic skills training, also contribute to informal sets of constraints. Amongst the few operators' associations that do exist, the most successful, the Confederation of Tanzanian Industry, mainly serves larger firms, the chamber of commerce is only partially reformed from its days as a quasi-government organization, and others have very small memberships and inadequate capability for an effective representative or advocacy role. Government was and still is under-developed and its reach into the community of small enterprises, formal or informal, is restricted by its limited capacity to administer regulations. In general, regulations are designed for large state-owned enterprises and are not adapted to the different character small-scale enterprises. In this environment, operators seek to evade regulations in order to create an area of institutional space more conducive to their survival, which provides opportunities for officials to collude with them in return for small bribes. Policy makers are aware that to enforce the present regulations strictly and without discrimination risks putting enterprises that are not in a position to comply with them out of business, and many fall into that category, which would be counterproductive for government's job creation goals. The institutional environment in which operators and government come together in a formalization transaction comprises these opposing informal and formal institutions, which structure operators' enterprise development strategies and their formalization decisions.

4 VOLUNTARY FORMALIZATION IN PRACTICE

4.1 Formalization Progressions

The case histories referred to in Table 1 illustrate how operators may remain at any level of informal or formal status for widely differing periods of time, from one year (Alan Mungo) to 29 years (Dan Himba)—see Figure 1. An operator may progress via a semi-formal stage, or graduate directly from informal status to the registration of a business name or limited company (Milly Zukkia; Richard Matsu). There is no apparent correlation between

Operator	<i>De jure</i> status of the enterprise					
	Informal		Semi-formal		Formal	
	Illicit	Licit	Hawker Licence	Local business licence	State registered business	Limited company
Milly Zukkia		○		4 years	○	→
Barnabus Kemba		○	8 years	○	6 years	○
Richard Matsu		○		6 years		○
Alan Mungo		○	1 year	○	3 years	○
Dan Himba		○	29 years	○	1 year	○

Figure 1. Formalization progression

the passage of time as a factor in the formalization process and the type of activity. Operators may use the informal sector as experimental space in which to make low-cost tests of the feasibility of their enterprise ideas, abandoning those that do not meet expectations (Barnabus Kemba; Richard Matsu) or, as in the case of Dan Himba, they may remain in the informal sector exploiting a series of *ad hoc* opportunities. In any case, the informal sector provides an operator with low-risk entrepreneurship learning space.

Of the formalization decisions shown, only one was taken under the threat of imminent enforcement (Barnabus Kemba when he first applied for a local business licence); in respect of others, operators accepted government formalization offers voluntarily at a time and for a purpose advantageous for their business activities. For informal enterprises, legal status enables an operator to conduct business openly and therefore determines the ceiling on the amount of business activity in which he or she can safely engage (Milly Zukkia¹) or the location in which it can be conducted (Barnabus Kemba²); for others, it confers a standing that may be demanded by other parties in business exchange transactions (Richard Matsu³), and it may provide technical transactional advantages, as does registration in the system of value added tax (VAT). In general, the cases indicate that during the formalization process operators can make choices—whether to formalize or not, when to formalize, how to formalize and for what purpose—and each operator uses them in different combinations that constitute different strategies for enterprise development within the given institutional environment.

4.2 Factors in the Enactment of Formalization Transactions

In the cases examined, operators' acceptances of the government offer of a formalization transaction generally coincide with a perceived opportunity to do business. Other

¹Milly Zukkia won an order for goods too large to smuggle by her usual method and then tried to obtain a licence.

²Barnabus Kemba was forced to relocate his enterprise to government-designated land where he could no longer operate without a licence.

³Richard Matsu wished to win contracts to supply state enterprises, which would only deal with registered companies.

incentives, such as property rights and legitimacy, are recognized (particularly by operators concerned with their family welfare and security in the longer term) but play the role of supporting factors, suggesting that the stimulation of an opportunity, if not the prime motive, is at least a necessary condition for voluntary formalization decisions and actions. Operators who decide to formalize find the enactment process to be lacking in co-operation from government officers and to be procedurally inefficient, having to address requirements set by different, poorly co-ordinated government bodies. Rather than being helpful in giving clear information and directions about how to comply with the pre-conditions for obtaining operating licences and certificates, some officers are (in the opinion of operators) deliberately unhelpful, obstructive and uncaring about the delays and costs resulting from their attitudes. The extreme example is when an operator must travel two or more days to reach the only available government office to submit an application, to be told the form is not correctly completed and to come back with it another day. Why not use the postal service? Because, say operators, the service is erratic and delivery is not guaranteed, government officials do not send out notification of receipt and, even if an application should reach its destination, officials are unlikely to respond; anecdotally, it is claimed they (the officials) prefer face-to-face situations that offer opportunities for personal benefit. Only the relevant Minister can approve a registration application, which is also a cause of delays. An examination of the procedural process faced by investors in Tanzania revealed dozens of possible steps (Coopers and Lybrand, 1996; ILO, 2001), which portends considerable transaction cost. After being directed to different government offices and receiving no help and insufficient information, Milly Zukkia actually abandoned her first attempt to obtain a state export licence; later she succeeded in one afternoon through the influence of an established manufacturer. Alan Mungo breached a tax regulation⁴ because, he says, he was unaware of it—he subsequently hired the tax official who led the process against him as a part-time ‘consultant’. Taxation is a particular area of conflict in which government claims the right to raise revenue from private enterprise, and operators resist on the grounds of poor or non-existent government services in return.

4.3 Strategic Aspects of Formalization

In general, in the formalization process as it is, negative factors appear to outweigh positive ones. The values of government incentives (such as legitimacy and rights) are unquantifiable and long-term and operators can discount them in the face of immediate financial costs. In the cases examined, the other main formalization transaction factors (information, co-operation, co-ordination and trust) are also close to having negative values.⁵ The factor that can redress the balance is a business opportunity and a strong prospect of profit dependent on legal status. In this context, whether to formalize or not, and when and how, are decisions about strategy, which is to say, about how an operator intends to interact with the institutional environment, taking into consideration formalization incentives, transaction costs and opportunities. Under these conditions, formalization can be regarded as a rational course of action only when an enterprise has begun to grow or when there is a near certain growth opportunity in prospect and the operator will be able to

⁴Reported in Nelson (2003), Alan Mungo failed to pay stamp duty invoices issued by him when they exceed a statutory value because he was unaware of the regulation requiring him to do so.

⁵Formalization transaction factors with negative values are consistent with the growing informalization of the economy.

meet increased transaction costs. In the event that the realization of the opportunity falls short of compensating an operator for leaving the shelter of the informal sector, the alternative strategy is to evade formal obligations and associated costs—informalization encroaching on the formal sector. If the business environment does not provide opportunities and security for growth of one enterprise, then an operator may choose the option of remaining in the informal sector and growing horizontally with a portfolio of micro enterprises small enough to avoid attracting official attention. Thus, high formalization costs can provoke reactive cost-avoidance strategies that perpetuate informalization as a survival and development strategy.

4.4 Formalization Choices

Two observable dimensions of change during formalization are (1) *de jure* status—informal, semi-formal, formal and (2) *de facto* changes of behaviour or structure—which can include: establishment of an enterprise as a managed entity governed by internal rules and systems, acquisition of an established clientele, impersonal relationships with clients, operational standards (touching employment, product quality, and environment protection), reinvestment of operational surpluses, acceptance of liabilities, strategic planning, membership of associations, technology upgrade and negotiating forward supply linkages in business-to-business activities. *De facto* formalization commonly takes the form of many small and imperceptible changes.

Having no *a priori* time limits or fixed relationships between phases of change, an operator enjoys considerable latitude for managing formalization progression. Nevertheless, a positive relationship emerges between the progressions of their experience, *de jure* events and *de facto* development. This was found when plotting the positions of nine enterprises in institutional space defined by *de jure* and *de facto*⁶ dimensions of formalization—shown in Figure 2 (Nelson, 2003).

It shows operator MZ (trader–export/import) at the start of her enterprise career representing one polarized informal position and DH (portfolio of formal companies) at the most mature stage of development representing another, formal one. The scoring process positions AM (wine producer) as also having reached a high degree of formalization. KK (tailor), though having made a good start in growing his enterprise, failed to establish and formalise it and achieves a low score in the system. Apparent anomalies are DM (wine producer), who reaches a high score after a relatively short time and whilst still informal, and JT, who also scores highly with a portfolio of informal and semi-formal microenterprises. On further examination, JT is more formalised *de facto* than her *de jure* position would suggest. One reason for this is that her growth strategy of accumulating a portfolio of microenterprises licensed with the local authority and some not licensed at all requires a greater degree of impersonal organization and management and a recognition of obligations to employees, customers and the local environment than it requires of legal status. DM's deviance from the norm is explained because he operates to a higher *de facto* level of formalization than should be expected of an informal operator; this is because his growth strategy is proceeding at a faster pace than his application for an

⁶*De facto* positioning is determined by an accumulation of weighted factors denoting greater or lesser degrees of formalization. It is assumed that each characteristic carries equal weight and the device of cumulative weighting moderates differences there may be. The device of using YES or NO types of ratings minimises the effects of value judgements.

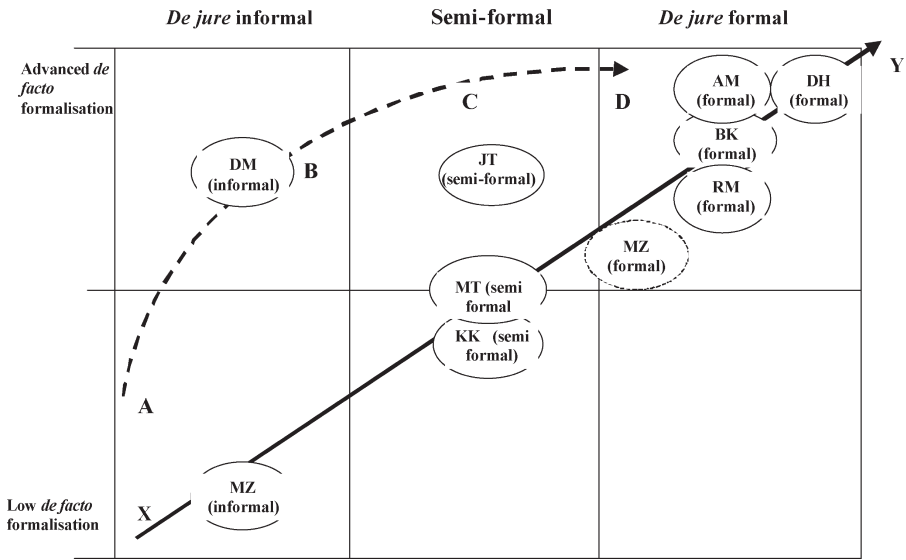


Figure 2. Plotting enterprise formalization in institutional space

operating licence (which is already more than one year old). MT operates her contract catering enterprise to higher standards than might be expected of the holder of a street hawker’s licence.⁷ Both DM and MT are engaged in forward linkages with other enterprises of a higher legal status and both set high standards in conforming to up-market product and service standards. The expected path of a developing informal enterprise is indicated by the distribution, from the lowest position occupied by MZ, towards the highest position occupied by DH. MZ is also shown in a second position to which she moved during this study. The distribution indicates that the norm for this group is for the pace of de facto formalization to match the pace of de jure formalization, and suggests that the evolution of informal sector enterprises may be monitored against the expected path of enterprise development, X–Y. An anomalous progression (A-B-C-D) such as that projected for DM is indicative of an obstruction encountered in the process of de jure formalization.

4.5 Decision Process

Cases show that three basic considerations bear upon operators’ formalization decisions: Institutional Incentives (II), which are the legitimacy, rights and benefits conferred by legal status; Opportunity Cost (OC), which is the loss of potential gains suffered when an operator decides not to formalize; Formalization Cost (FC), which is the cost to an operator of enacting a formalization transaction with government. Formalization costs include all costs incurred as a result of formalizing, including the costs of preparing and submitting a licence application, licensing fees, taxes, and costs of complying with prior conditions and subsequent regulatory obligations, and the cost of time lost through bureaucracy and intangibles, such as stress. The balance of the values of these factors is

⁷Actually, she is not a street hawker, but operates under that licence to avoid taxes.

presumed to represent the strength of a Stimulus (S) to formalize. The stimulus is the prospective value of finding an enhanced institutional environment in the formal sector. This model can be stated as: $S = \Pi + OC - FC$. The institutional incentive comprises a number of factors, for example, legitimacy and the prospect of benefiting from new rights, to which operators must assign personal values. Opportunity cost can in principle be calculated if it is related to a specific opportunity, such as an invitation to tender for a public sector procurement contract. The model is generalisable to different situations in which the factors may be active to a different degree. For example, in his informal phase, Dan Himba pursued ad hoc moneymaking opportunities and there is no evidence that he considered or needed to consider formalization costs or institutional incentives, which were therefore dormant factors in his decision making at that phase of his development. Formalization costs fall into two categories; some of them, particularly *de jure* costs, are payable immediately as a condition of being granted legal status, whilst *de facto* costs are generally incurred later in the process of enacting a transaction. The distinction between immediate and delayed formalization costs is introduced into the model as follows: $S = \Pi + OC - (IFC + DFC)$ where immediate formalization costs (IFC) would normally include all up-front costs—the preparation of a licence application, licence fee, and advance tax payments and the cost of satisfying pre-licensing condition. Deferred formalization cost (DFC) would normally comprise costs such as value added tax, direct income tax, employment taxes and compliance with any regulatory provisions that were not satisfied as pre-conditions of the transaction. Based on these perceptions, the following relations can be observed:

1. The higher the opportunity cost (OC) and the greater the value assigned to the other incentives and benefits of formalization (Π), then the stronger is the stimulus (S) to formalise.
2. When opportunity cost (OC) is an estimate, it is subject to variable optimistic or pessimistic evaluations by individual operators.
3. Institutional incentives that are non-money benefits, such as general property rights, or general borrowing potential, are given variable subjective evaluations by different operators.
4. The lower the combined formalization costs (FC), the stronger the stimulus (S).
5. The higher the proportion of deferred formalization cost (DFC), the more formalization cost can be subjectively discounted (S).

Due to unavoidable subjective elements in the decision-making model, decisions will be influenced by an operator's personal characteristic traits, such as self-confidence, attitude to risk and, as mentioned above, optimism and pessimism at the time a decision is taken. The effect of subjective influences in decision-making is to reduce the predictability of operators' decisions.

The relevance of the decision model in the institutional positioning of an enterprise is demonstrated in the case of David Mungo. Once he had developed a marketable product and identified market opportunities for expansion, he decided it would be in his interests to legitimize his enterprise. Cautiously, he made preliminary enquires and found that the premises he used, being a motorcar garage in the grounds of his dwelling house, would not be approved by health inspectors, which meant he would not be able to apply for an operator's licence. About this time he attended a meeting between representatives of TAFOPA, the association of food processors, the local trade licensing officer and a representative of the Ministry for Food, where it was agreed that small-scale food

processors who could not comply with regulations would not be forced to cease their operations, instead they could continue to operate without licences, but still be subject to supervision by health inspectors. Without licences they also, incidentally, had the advantage of being off the database⁸ of operators liable to pay formal taxes. The acknowledged reason for the Ministry's decision was that Tanzania's food processing industry was important, relied mainly on small-scale producers, most whom were not licensed⁹ and would be forced to close if regulations were enforced. As a result, David Mungo was able to continue operating and *de jure* licensing costs were deferred until after he had brought his premises up to standard or moved to different premises. At this point, his *de jure* formalization costs were very low, limited to the value he placed on his own time in consultation with local officials and to paying their 'expenses' incurred while making informal inspections of his premises and for their advice. He had faith in his product and there was little to detract from the stimulating combination of incentives and opportunity cost, and he continued to invest in *de facto* formalization.

Case: David Mungo

Institutional incentives (II)

The institutional incentives in this case (reduction of uncertainty of treatment by officials, relatively secure property rights in the longer-term) are relevant to the operator's stated aims—to build a secure future for his family.

Opportunity costs (OC)

Opportunity cost is given a high value due to investment in product quality, product standards subsequently achieved and good test-marketing results for his product

Formalization cost (FC)

Formalization cost is deferred as a result of the agreement between TAFOPA and Ministry officials; the cost of meeting preconditions for a business operator's licence (upgrading premises) amounts mainly to an investment in capital assets and not a tax (it is not lost money); the remaining immediate costs are of lower value than institutional incentives and opportunity costs.

Stimulus (S)

The resultant stimulus is of sufficient strength to trigger formalization action. The fact that the legal procedures are delayed awaiting compliance with some regulations is a temporary factor in the process.

On David Mungo's migratory path (Figure 2), starting from the informal position 'A', *de facto* formalization of the enterprise leads the process and was later followed by a successful application for a licence, resulting in the path A-B-C. This may be followed by a step into D (registration of the business or its incorporation as a company). The effect of *de facto* formalization on the development and performance of the enterprise in this case is partly responsible for raising the value of the opportunity cost (market advantage and potential) associated by the operator with *de jure* formalization and, as a result of that, the strength of the stimulus to continue the formalization process. He demonstrates a decision

⁸Being on or off such a database affects visibility to tax authorities rather than the liability to pay taxes.

⁹Ms Khan, Deputy Minister for Industry and Trade, reported in the Financial Times, 14 June 2000, Dar es Salaam (*Small-scale food processing firms lack legal protection-Khan*).

model that embraces practical factors—commitment to and investment in product development raises opportunity cost, a first tentative approach to the local government authority helps to coordinate the formalization transaction and establish a basis for trust and co-operation between the parties, which increases the efficiency of the transaction and defers formalization costs without any penalty. Before he made his approach to public officials, however, he had used low-cost informal institutional space in which to experiment and create a viable product and enterprise.

The Dan Himba case illustrates a change of strategy in response to changing circumstances. For a long period of time his preferred strategy was to conduct informal enterprise activities as a supplement to his salaried employment, which resulted in an exceptionally slow start to formalization, before which he enjoyed a long run of starting informal enterprises, maximizing profits while he could and abandoning them when they showed signs of having run their most profitable life cycle. During this long period of activity, the following conditions pertained:

Case: Dan Himba

Institutional incentive (II)

Institutional incentives to remain in paid employment (occupational status and security of employment) were rated more highly than the acquisition of business property rights and other incentives to formalize personal enterprise activities.

Opportunity costs (OC)

Given the opportunities available whilst remaining in the informal sector, the opportunity cost of foregoing formalization was not highly valued.

Formalization costs (FC)

The cost of formalization was perceived to be high in relation to opportunity cost.

Stimulus (S)

The resultant stimulus to formalize *de jure* was low.

Later, the conditions of his employment deteriorated and caused him to assign a new set of values to the decision equation: then he re-evaluated downwards the institutional incentives to remain in employment, re-evaluated upwards the opportunity costs of a formal entrepreneurial career, and re-evaluated downwards the relative weight of formalization costs. The result of this was to make a full-time entrepreneurial career more attractive and increase the stimulus to formalise, and he abandoned his job for a career in private enterprise instead. This change of strategy, explained with reference to the formalization decision equation, further demonstrates the scope for an operator to manage the formalization progression.

4.6 Coping Strategies

Coping strategies emerge from formalization choices and decisions taken under conditions of uncertainty about benefits and costs, when operators are assumed to rely on optimistic assessments of the risks of their actions (it would not be rational to proceed on the basis of pessimistic expectations). Optimistically, the costs of voluntary formalization decided in the pursuit of business opportunities would be covered by increased profits. If such optimism is not vindicated by events an operator must reduce costs. In the context of developing economies, the transformation costs of most informal and other small-scale

enterprises are already pared down to a minimum¹⁰ and the target for cost-cutting is formalization. There are many ways in which the costs of formalization can be reduced, but they fall into three main categories: (1) operators avoid making the investment necessary for compliance with regulations (which accounts for the large proportion of low quality enterprises in a developing economy); (2) they withhold or falsify information that would inform authorities of their true tax liabilities; (3) they enter into informal arrangements with public officials to evade formal obligations. Tanzanian cases show that operators are not prepared with adequate information about the true costs of enacting a formalization transaction with government and invariably resort to cost-evasion as a strategy for survival in the formal sector. Taking all circumstances into account, there is little difference between small-scale enterprises at the margins of the formal and informal sectors, except that some have acquired legal status—all of them may adopt the same informal orientation as a strategy for surviving in their respective institutional environments.

5 GOVERNMENT PRACTICES

In Tanzania, there is no official distinction between informal and formal enterprises and in principle the regulatory system applies equally to both. On the government side, the formalization process follows the following sequence of actions: (1) decide the terms of the transaction offer, (2) provide relevant information to enterprises, (2) process applications from enterprises wishing to accept the offer, (4) enact the *de jure* part of the transaction and (5) enforce the prescribed terms. Though little of the regulatory system is changed from that established for state enterprises in the context of a one-party socialist state, efforts are being to reform policy and central government agencies. In 2000 a new Business Registration and Licensing Agency (BRELA) came into operation with a three-year plan of action to review the policy and legal framework for regulating and facilitating business. In its own promotional leaflet, BRELA lists the incentives for formal registration: a business undertaking with a legal life, exclusive right to a company or business name, the right to enter the competitive business arena, exclusive legal rights to inventions or innovations, the protection of intellectual property rights, the protection of marks and artistry against infringement and piracy, being able to enjoy the pride of being honest, and the opportunity to contribute to national economic prosperity. The Tanzanian press, however, is not convinced that BRELA has the capacity to enact its own role in the transaction.¹¹

The advocacy system for small-scale enterprises is weak. The most firmly established private sector association draws its membership from large and medium-sized firms, which it explains on the grounds that smaller firms cannot meet the membership criteria.¹² The chamber of commerce, which was a government organisation with a state function, has lost its former government budget and has not yet adapted its activities to the needs of a private small-scale enterprise constituency. Sectoral associations are embryonic and weak. Taking the food processors' association as an example, it was established in 2000 to

¹⁰Consistent with low technology and lack of economies of scale.

¹¹'Licensing agency no panacea to business problems.' In: *Business Times*. 23 June 2000, Tanzania.

¹²At the time of this research the association was seeking financial assistance from donors to support a training programme to assist smaller firms to meet membership criteria.

serve one of the country's most numerous sectors comprising mainly informal enterprises. The association was set up under the auspices of a donor funded programme to train small processors in business and technical skills and completion of the programme was a condition of membership. By 2002 the programme had trained more than 2000 participants and the association claimed a membership of 200, none of whom had been successful in gaining an operator's licence. Power is therefore unequally distributed in favour of government in the bargaining mechanism.

The Food Control Commission and the Tanzanian Bureau of Standards control licensing. In a two-day workshop attended by representatives of the Ministry of Industry and Trade, small food processors 'pleaded to the government to legally support young small scale enterprises towards increasing incomes for Tanzanians'. The Deputy Minister, Ms Khan, claimed that most food processing enterprises in Tanzania fail to register with the Food Control Commission (FCC) because their premises do not meet the specifications required under the Food Control Ordinance (FCO), and therefore they do not qualify for help from the Commission. She said, 'Unfortunately the ordinance focuses on medium and large enterprises leaving micro and small scale enterprises in a vacuum'. Because they are unlicensed they fail to qualify for any government assistance that might help them.¹³

Government bodies at ministerial level determine the formal terms and rules, but the enactment of formalization transactions is conducted mainly at local government level, sometimes informally, where operators of enterprises recount the uncertainties and difficulties they experience, ranging from having to pay government officials to perform their registration duties or perform them diligently, to aggressive and unpredictable enforcement tactics often resulting in the enforced closure of enterprises or consequential cessation of activities. Their experiences indicate that central government, though possessing the necessary power to determine rules, has so far failed to establish a facilitative formalization environment. Ministerial personnel are in the process of formulating pro-small enterprise policies, but this is a long process and is not always successful. A draft policy paper on 'Micro enterprise and informal sector promotion' was produced in 1995, followed in 1996 by the Sustainable Industrial Development Policy, which stated under Section 3.5.2, 'The government will assist the informal sector to gradually enter the formal sector so as to benefit from facilities available in the formal umbrella of Small and Medium Enterprises (SMEs). This will be carried out within the framework of the government policy on the informal sector', but that policy was never ratified. Instead, a Small and Medium Enterprise Policy was adopted in 2004, early drafts referred to the formalization of informal enterprises but were deleted from the final version. Once it was adopted, the government commissioned an assessment of capacity development needed to implement it. One of the obstacles is the lack of capacity to co-ordinate ministerial activities in support of the policy. Another is the lack of capacity to reform administrative culture and practices, especially at local government levels, but one exceptional indication of how this may be approached is provided by the Tanzanian Revenue Authority, which introduced proposals to train tax collectors in the principles of customer care—interestingly giving enterprises the status of 'customers' to be cultivated rather than merely sources of revenue to be exploited. It will take time to see if the experiment will be sustained and if it alters relationships for the better.

¹³*Financial Times*. 14 June 2000, Tanzania (op. cit).

6 CONCLUSION

Being informal refers to an operator's position in relation to the prevailing institutional environment, acting outside of the government system of regulation. Formalization is the abandonment of that position through a change of form and orientation during which an enterprise becomes established within a different framework of norms and rules of behaviour that raise transactional costs. Voluntary formalization is an exchange transaction between an operator and government in which the operator accepts the government offer of legal status with legitimacy and rights in exchange for an implied agreement to comply with government regulations. During the enactment of the transaction, an enterprise adapts to its new institutional position by adopting a coping strategy that offsets transactional costs against the benefit of improved business performance and/or by adopting cost-reduction or evasion tactics.

A highly formalized position is one in which an operator has established an enterprise as a separate legal entity from him or herself, governed by internal rules and systems, complying with market rules and practices and those of the formal business community, benefiting from the legitimacy and rights of legal status, complying with the terms of the formalization transaction, including regulations protecting employees, consumers, the environment and contractual parties. In this respect, formalization can be regarded as a measure of the quality of enterprises in an economy. Both the growth and quality of a formal small-scale enterprise sector in a developing economy is determined by whether or not enterprises can meet, first, the cost of pre-conditions of entry to the *de jure* process of formalization and second, the cost of *de facto* compliance with subsequent obligations. Government sets the terms of a formalization transaction. Terms that are too costly obstruct the entry of small-scale enterprises to the first step in the formalization process and render other government initiatives to facilitate the process redundant (such as access to business development services). Enterprises that do enter the process and find it too costly respond by adopting evasion tactics that place them outside of the law again.

Factors that work against government include (1) an unreformed system of legislation and regulations, (2) an administrative culture low on empathy with the small-scale sector, (3) the lack of private sector organisations competent to participate in a dialogue with government on behalf of informal and small-scale enterprises, (4) a general failure to recognise formalization to be an exchange transaction on terms needing the agreement of both parties. The challenge for government is to incorporate the spirit of exchange as an element of economic development. A conscious relationship with each informal operator is not feasible for central government and the aim must therefore be to strike a bargain on terms with the informal sector through its representatives. Some underlying principles seem inescapable: for example, entry terms to the formal sector should attract rather than repulse informal operators; approved institutional space need not be reserved for only one (formal) type of enterprise, it may also accommodate subsistence enterprises and others experimenting with the feasibility of a business idea; voluntary co-operation to achieve joint benefits from personal enterprise must produce more satisfactory results than conflict. Finally, the enforcement of agreed terms carries more moral weight than the enforcement of imposed terms not adapted to the particular circumstances of small-scale enterprises.

The informal sector flourishes partly because it offers opportunities of economic necessity to the poor, partly because it offers a low cost arena for experimentation with business ideas that can lead to business growth, and partly because of government

tolerance—to change any of these conditions risks incurring the cost of damaging fragile enterprises and livelihoods for little benefit and suppressing business experimentation and development. Informal enterprises are a heterogeneous collection of subsistence, experimental, *ad hoc* and established enterprises in all sectors of industry and commerce, run by an equally heterogeneous collection of owners from all strata of society. Individual cases exist to illustrate their potential for development, but the progression of each one is different and unpredictable. Uncertainties in formalization transactions place a high need for trust and good faith and an intention that each party should place mutual interests above self-interest. As a step towards creating an environment more conducive to small-scale enterprise development, it would be appropriate for policy developers first to consider formalization in the spirit of an exchange transaction based on agreed terms, with implications for supporting the development of small-scale sector associations to participate in governance and an appropriate bargaining mechanism.

REFERENCES

- Castells M, Portes A. 1991. World beneath: the origins, dynamics, and effects of the informal economy. In *The Informal Economy: Studies in Advanced and Less Developed Countries*, Portes A, Castells M, Benton LA (eds). The Johns Hopkins University: Baltimore; 11–40.
- Coopers, Lybrand. 1996. *The Investor Roadmap of Tanzania*. USAID: Dar es Salaam.
- Deakins D. 1999. *Entrepreneurship and Small Firms*, 2nd edn. MacGraw-Hill: London.
- De Soto H. 2000. *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*. Bantam Press: London.
- Ferrand D. 1999. *Discontinuity in Development: Kenya's Middle-scale Manufacturing Industry*. University of Durham: Durham.
- Frese M, ed. 2000. *Success and Failure of Microbusiness Owners in Africa: A Psychological Approach*. Greenwood Publications: Westport, CT.
- Harrison D. 2000. Formalization—the major criterion of success in developing countries. In *Success and Failure of Micro Business Owners in Africa: A Psychological Approach*, Frese M (ed.). Greenwood Publications: Westport, CT.
- Heilman B. 1998. *Capitalism as a Social Movement: The Case of Tanzania During the Mageuzi Era*. Indiana University Department of Political Science: Indiana.
- ILO. 1972. *Employment, Incomes and Inequality: A study for Increasing Productive Employment in Kenya*. International Labour Organisation: Geneva.
- ILO. 2001. *Roadmap Informal Sector Study for Tanzania Mainland*. ILO: Dar es Salaam.
- ILO. 2002. Decent work and the informal economy. In *International Labour Conference, 90th Session, Item VI*. International Labour Organisation: Geneva.
- Knight J. 2001. Explaining neoliberalism. In *The Rise of Neoliberalism and Institutional Analysis*, Campbell JL, Pederson OV (eds). Princeton University Press: New Jersey; 28–50.
- Levi M, Sherman R. 1997. Compliance with rationalised bureaucracy. In *Institutions and Economic Development: Growth and Governance in Less-Developed and Post-Socialist Countries*, Clague C (ed.). Johns Hopkins University Press: Baltimore; 316–342.
- Luvanga NE. 1997. *Gender differentiated impact of structural adjustment programme on women's employment in the private sector*. National Workshop on Women's Employment in the Context of Structure Adjustment Programmes in Tanzania, Dar es Salaam.
- Mahemba CM, De Bruijn EJ. 2003. Innovation activities by small and medium sized manufacturing enterprises in Tanzania. *Creativity and Innovation Management* 12(2).

- Nelson EG. 2003. The voluntary formalization of informal enterprises in a developing economy—Tanzania. University of Twente, The Netherlands.
- North DC. 1990. *Institutions, Institutional Change and Economic Performance*. Cambridge University Press: Cambridge.
- Olomi DR. 2001. *Entrepreneurial Motivation in a Developing Country Context*. Dar es Salaam: University of Dar es Salaam, Faculty of Commerce and management.
- RSIE. 1988. *Development of Rural Small Industry Enterprise, Lessons from Experience*. Vienna: ILO.
- Spring A, McDade BE. 1998. *African Entrepreneurship*. University Press of Florida: Gainesville.
- Storey DJ. 1994. *Understanding the Small Business Sector*. Routledge: London.
- Tripp AM. 1997. *Changing the Rules: the Politics of Liberalization and the Urban Informal Economy in Dar es Salaam*. University of California Press: Berkeley.
- Yin RK. 1994. *Case study research: design and methods*. Thousand Oaks: Sage Publications.