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INTEGRATION INTO FORMAL ENTERPRISE SPACE:  
CHALLENGES AND OPPORTUNITIES FOR INFORMAL  
SECTOR ENTREPRENEURS

**P. Koshy**

**January 2019**

## Integration into formal enterprise space: Challenges and opportunities for informal sector entrepreneurs

P. Koshy<sup>1</sup>

### Abstract

A vast majority of micro and small enterprises (MSEs) operate in an informal enterprise space, functioning without the required legal and regulatory approvals, notwithstanding crucial role that they play in job creation, poverty alleviation, exports and regional economic development. Living in an informal enterprise space is a not a choice, but forced reality brought on by regulatory burdens, complex compliance structures and an inefficient and slow-moving government system.

This article looks at the informal MSME sector in terms of the challenges and opportunities on its route to formalization. It highlights some of these important aspects, which facilitates the transition into a formal enterprise space. IT has provided inputs resulting from interactions with entrepreneurs, associations and NGOs working in the informal MSME space. The study was also supplemented by secondary source materials. Some of the sectors that have been evaluated are waste management and recycling, last mile public transport connectivity operators, handloom weavers, potters and street food vendors.

Keywords: Informal sector; Small Enterprises; institutions and reforms

JEL Classification: L 26; L 51; L 52 O 25

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## **Integration into formal enterprise space: Challenges and opportunities ahead for informal sector entrepreneurs**

P. Koshy\*

### **Introduction**

A vast majority of micro and small enterprises (MSEs) operate in an informal enterprise space, functioning without the required legal and regulatory approvals, notwithstanding crucial role that they play in job creation, poverty alleviation, exports and regional economic development. Living in an informal enterprise space is a not a choice, but forced reality brought on by regulatory burdens, complex compliance structures and an inefficient and slow-moving government system.

The sector comprises all unincorporated private enterprises owned by individuals or households engaged in the sale and production of goods and services operated on a proprietary or partnership basis and with less than ten total workers. (Radhakrishna, 2012) These units typically operate at a low level of organization, with little or no division between labour and capital as factors of production and on a small scale. Labour relations are based mostly on casual employment, kinship or personal and social relations rather than contractual arrangements with formal agreements. (ILO, 1993) Inclusive growth can be achieved by facilitating their formalization along with economic growth, decent jobs, better working conditions, social protection and enhanced tax collection. (Economic Survey, 2015-16). Enterprise formalization is part of a sustainable development agenda. (UN, 2015) Transition to a formal enterprise space is also outlined in ILO Recommendation 204. (ILO, 2017)

### **Focus areas in transition agenda**

Formal enterprises stand a better chance of growth, exploiting market potential, reaching out to new markets, accessing finance and adopting technologies. Being in the formal space gives them a significant advantage as they receive access to government schemes, subsidies, incentives, technology up-gradation support and finance, including collateral free loans. Legally incorporated and registered entities can operate fearlessly without harassment from the law enforcement agencies. The opportunity that it opens for them to participate in public biddings is yet another aspect.

### *Features of Informal enterprises*



### **Reform areas in enterprise ecosystem and regulatory framework**

There are a number of challenges that informal SMEs have to overcome and address before becoming part of a formal enterprise space. Registration, acquiring legal status, bank accounts, local government permissions are all pertinent aspects. Various inputs used in manufacturing, skills and certifications and educational levels of the workers, work conditions and standards, if child or bonded labour involved in the manufacturing, or any instance of human rights violations, technology, managerial and accounting practices are all other issues involved in the transition. <sup>i</sup>



*Reforming business laws: Scrapping of unwanted and archaic rules and procedures:* Doing away with archaic rules and reforming business laws are important aspects in the transition agenda. In the United States, to launch a sole proprietorship only requires a tax identification number from the Internal Revenue Service. Whereas in most cases, SMEs must have a formal legal status to operate and enter into contracts. Cumbersome, unclear, or unpredictable incorporation and registration requirements are often a key cause of informality. (Ramos, 2016) High compliance burden and inefficiencies act as a disincentive for entrepreneurs to be part of a formal system. (Koshy P. , 2018) This could make their products and services too expensive. (Rajagopalan, 2018)

*MSE friendly taxation system:* Tax policies ideally have to act as an effective tool in the hands of the governments to support MSE sector. It can certainly contribute in dissuading MSEs from continuing their operations. Designing the tax system with simple procedures keeping in mind the needs of the sector is of vital importance in the process of transition from informal to formal enterprise space. It could create a friendly business climate. (OECD, 2015; Abdul-Jabbar, 2008; European Commission, 2007) However, the case is different and tax departments are seen as the most unfriendly, corrupt and scary part of the system.

*Enhanced productivity, skill development, education and training:* Many of the informal and micro enterprise face real threat of extinction due to competition and global market realities. Helping them realize the threat scenario itself would be a starting point towards formalization and educational outreach. (Koshy P., 2012) They are happy to remain in the prevailing status and are not eager to adopt technology, learn new skills and upgrade or expand to new areas. Some of the basic skill sets and training needs are accounting, marketing & sales, customer relationship, GST compliance awareness, and sector specific training and skill enhancement. Skill, training and networks to address the

educational needs of the sector have to be an integral part of the formalization strategy and the eco system.

*Addressing social and environmental concerns:* The sector is characterized by lack of social security, less than the minimum wages and poor occupational safety and security provisions are some other concerns. Child labour and poor labour standards that violate human rights are also issues in some of the informal sectors, for instance brick kilns, carpet making, textiles, garments, some agro based industries.<sup>ii</sup> (SOMO, 2014; ILO, 2007) As per NSSO survey 2009-10, there are 4.9 million child workers estimated to be involved by different productive activities (PIB, Ministry of Labour, 2012)<sup>iii</sup> Poverty, malnutrition and spread of TB also prevalent commonly in many sectors<sup>iv</sup>. If MSEs have to sustain themselves as partners in the global value chain, responsible business issues cannot be ignored, particularly aspects like child & forced labour, safety at work, decent wages and green enterprise practices, as consumers world over are increasingly aware and demanding that the products that they consume are not an end product of unethical enterprise practices.<sup>v</sup> (EC, 2013) They insist that global value chains abide by the principles of sustainability, values & labour rights at enterprise level and adhere to green enterprise practices.<sup>vi</sup> (EU Parliament , 2018)

Indicator	Reforms/improvement needed	Action required	
		Informal	Formal
Legal status	Legal registration/license to operate/permits	No registration or legal status	Registered and operate with licenses, permits after fulfilling legal requirements
Taxation	Tax registration/file tax returns/obligation to pay taxes		
Technology	Transition to formal enterprise space involves	<ul style="list-style-type: none"> <li>Advanced technology adoption</li> <li>Green technology option and their adoption</li> <li>ICT adoption</li> </ul>	
Labor	Improvements in labor status required	<i>Enterprise workspace to be free of:</i> <ul style="list-style-type: none"> <li>Child labor</li> <li>Forced labor</li> <li>Better work conditions</li> </ul>	
Access to finance and banking services	Facilitating access to financial services, credit and banking services Supporting entrepreneurs even after given a loan; technical advice in marketing, technologies and any other guidance		
Market access Government contracts, procurement by the gov. agencies	Local and neighborhood markets and limited market Global market reach out potential customers		
Enhanced procurement by Global Value Chains	INTEGRATING SMEs INTO GLOBAL VALUE CHAINS Addressing labour standards Address Child labor, Forced labor Green technology		

### Select case studies of informal sector enterprises

Each of the sectors has their special characteristics and challenges vary. Some of the sectors are operating side by side with formal and whereas some sectors have no legal sanctity. In the following section some of the cases of informal sector are explored, based upon interactions with entrepreneurs, associations such as Federation of Cycle Rickshaw Pullers Associations (FoRPA), All India Kabadi Mazdur Mahasangh (AIKMM), potters and street vendors organizations as well as weaver communities and supporting NGOs.

**Handloom sector:** Handloom weavers are mainly from the weaker sections of the society. They make clothes for household needs. The informal nature of the enterprises cause a decline in the number of active units. Low productivity, low income, low wages, lack of social protection are other issues. According to New Culture Society working in Sambalpur district of Orissa, “weavers who are outside the purview of a co-operative don’t get support. Lack of direct market access, traders and exporters taking away the benefits of the hard work of the real weavers are some other issues. “Due to informal nature of handloom units, there is no direct loan to weavers. Look alike and similar designs from large textile sector are bringing down the cost of original weaver made products. though technology to reduce labor contribution is available, those technologies are not reaching the weavers . Handloom industry needs critical support and handholding to help them to move towards formalization” says Kishore Chattaria of the NGO New Culture Society.

**Potters:** Primarily a rural, disorganized sector, operates without any application of modern day technical support. The ability to respond to the market demand is limited. It has been estimated that over 40 lakhs rural potters still work with the help of conventional pottery wheels. Of the 15 lakhs traditionally skilled potters, about 95% are involved in the work of conventional red local pottery.<sup>vii</sup> In addition, the products made in the village pottery are only sold locally, at the village weekly haat’s level. According to Harpreet Ahulwalia, technology, better designs and responding to market demands are crucial.<sup>viii</sup>

**Cycle rickshaw pullers:** Cycle rickshaw pullers are found in each and every city. According to FoRPA, there are around 15 million cycle rickshaw pullers in India .<sup>ix</sup> Formalization and modernization of the sector offers many opportunities. Better designs solar and e-rick technologies are beneficial. Issuance of identity card and ownership of rickshaws will benefit them.. “Currently most of the rickshaws are rented out. Health issues are a concern as cases of TB are many. The conversion of ‘Rickshaw Heavers’ in to ‘E-Rickshaw Drivers’ are taking shape swiftly. The number of electric rickshaws on Indian roads is about to reach four million, which includes a large number of unemployed youth in addition to rickshaw heavers. Increase in their average income, which earlier was around “INR 200 to 350”, as pedal rickshaws and after shifting to electric rickshaws it goes upto “INR 600 to 900”.

**Food sellers:** Bipin and Ratan, two boys, manage a small business that sells cooked meals, in an East Delhi suburb. They make an average profit of approximately INR 2,000 every day. They have no bank account and no registration with the municipality. They are earning good profit. There is potential for

further growth, expansion and diversification of their business. They can be saved from harassment law enforcement agencies, to the least with the legal status. There are several possibilities if they are in the formal sector.

**Handicrafts:** The Indian handicrafts industry is fragmented, with more than seven million regional artisans.. Metal ware, Wood ware Hand printed textiles, embroidered goods & Shawls, Carpets, Bamboo products are few of the select sectors. While its products have overseas markets, the artisans do not get much benefit from the exports and remain poor.

**Snake charmers as barefoot conservation educators** Snake charming is an age old activity for generating some livelihood.<sup>x</sup> However it is not legal anymore. Snake charmers are shifting to street vending, waste collection & scrap business, construction workers and domestic maids, says Kishore Chatter. They could be provided training in order to help them find alternative livelihood sources. There are suggestions from 'Eco conservation' activists, that "employment of snake charmers as 'barefoot conservation educators'" could be another solution as this will recognize their indigenous knowledge and protect their culture and also assist in the protection of thousands of snakes killed through ignorance by the common people. (Bahar Dutt, 2005)

**Waste workers/E-waste recyclers/Rag pickers:** Informal entrepreneurs dominate the waste management sector. According to AIKMM, an organization of waste entrepreneurs, millions of workers are involved in waste collection, sorting, recycling and selling material thrown away and they contribute in reducing carbon emission and save energy in handling the waste and support municipalities. They face harsh working conditions, low social status, have deplorable living conditions and very little government support. They are unrecognized in legislation and criminalized by the administrations, according AIKMM.. They are not part of the public solid waste management systems and are socially invisible and seldom reported in official statistics. Electronic waste, which is hazardous, are treated by informal workers, and are vulnerable to health and environmental risks. Improving occupational safety and health, upgrading skills, better incomes and living conditions are critical.

**Attempt to formalization-** Harit Recyclers' Association (HRA), formed with the Informal Waste Entrepreneurs Association- AIKMM- is providing a formal platform, licenses and required legal basis for informal workers to operate legally. With the E-waste license to collect and recycle, members of HRA can operate formally. HRA has 17,000 informal waste collectors as members, in and around Delhi and can engage in electronic waste management work legally.

### CASES OF Informal MSE sectors

Sector	Status	Suggestions/best practices
<b>Street food sellers</b>	<ul style="list-style-type: none"> <li>• Unregistered firms</li> <li>• Contribution to domestic economy</li> <li>• Limited education of the entrepreneur/s</li> <li>• Most vendors do not cross the qualifying turnover of GST, which is INR 2 million p.a ( there may be exceptions)</li> <li>• Cash based transactions</li> <li>• No bank account</li> <li>• No dependency on financial institutions</li> </ul>	<ul style="list-style-type: none"> <li>• FSSAI is registering them and providing training for food safety and standards. States are in process of identifying and formalizing them</li> </ul>
<b>Handicrafts sector</b>	<ul style="list-style-type: none"> <li>• largest employment generators</li> <li>• Most of the items come from informal rural and cottage industries and from traditional handicraftsmen</li> <li>• Middlemen gets the benefit</li> <li>• Low wages and income for the real manufactures</li> <li>• Aspects like child labor prevails in some sectors</li> <li>• For many manufacturers/makers: NO DIRECT LOAN</li> <li>• Finance still a problem so many operate as laborers of middlemen ( kind of forced labor)</li> </ul>	<p>Market access and marketing support to handicrafts units in villages/rural hubs</p> <p>Improved access to finance</p> <p>Trendy designs and training in to be made available directly to the handicraftsmen</p>
<b>Handloom weavers ( Sambalpur Handloom weavers: one of the largest hub of handloom sarees)</b>	<ul style="list-style-type: none"> <li>• Weaver communities skilled in this dominate the manufacturing</li> <li>• Most of them have very little education</li> <li>• No Direct market access</li> <li>• Involvement of middlemen( traders/businessmen)</li> <li>• NO DIRECT LOAN to weavers</li> <li>• modern technology are available to reducing the labor hour and cost for weavers</li> </ul>	
<b>Snake charmers</b>	<ul style="list-style-type: none"> <li>• A traditional sector</li> <li>• Snake charming activity and making snakes dance as the snake charmers play the flute in various street corners</li> <li>• Though illegal as per wild life conservation act, still prevails</li> <li>• Livelihood is in danger</li> </ul>	<ul style="list-style-type: none"> <li>• Alternative livelihood</li> <li>• Training and skill development in other areas</li> <li>• The employment of snake charmers as 'barefoot conservation educators' and the recognition of their indigenous knowledge</li> </ul>
<b>Informal waste recyclers ( E-Waste/plastic waste etc) ( Informal sector dominate waste management sector in India)</b>	<ul style="list-style-type: none"> <li>• Primitive technology use</li> <li>• Hazardous materials exposure</li> <li>• Safety and security concern</li> <li>• No registrations, legal formalities</li> <li>• Unhealthy living conditions</li> <li>• child entrepreneurs getting exposed to hazardous conditions</li> <li>• Lack of education</li> <li>• Cases of high rate of Tuberculosis among waste entrepreneurs due to their constant exposure to waste materials</li> </ul>	<ul style="list-style-type: none"> <li>• Informal recyclers cooperatives with a common license (Case of Harit Recyclers association, New Delhi)</li> <li>• Without compromising waste ownership to waste pickers approach</li> </ul>
<b>Public transport: Last mile connectivity providers ( Rickshaw operators, E-rickshaws, E-rickshaws providing services to businesses)</b>	<ul style="list-style-type: none"> <li>• Most entrepreneurs do not own their vehicles</li> <li>• Due to lack of meters face challenges like uniform charges per km</li> <li>• Charges depend on bargaining capacity</li> <li>•</li> </ul>	<ul style="list-style-type: none"> <li>• Metered rickshaws</li> <li>• Opening of bank accounts</li> <li>• Ensuring finance for buying rickshaws</li> </ul>

### **Obstacles in the route to formalization**

- Lack of awareness about the benefits of being in the formal sector
- Many entrepreneurs are illiterates
- Digital literacy is yet another aspect critical while enterprises need as they move towards a formal enterprise space
- Financial and accounting literacy is another area that is to be focused on
- Certain sectors are incompatible to be formalized do to illegal nature of their businesses
- Lack of incentive for enterprise in some sectors to migrate to formal enterprise space.
- Operating formally can be more expensive, therefore they prefer to operate informally.
- Seasonal entrepreneurs find it burdensome to register and comply

### **Suggestions and plan of action: Supportive ecosystem to facilitate transition**

*Enterprise Resource Centre:* A framework of self-supporting ecosystem wherein they can thrive would facilitate their growth and sustainability. An enterprise ecosystem with a wide network, presence, with knowledge and infrastructure backup can support informal MSEs in transition by providing various links in the ecosystem providing the crucial supports.

They can provide crucial inputs, assistance, documentation support, legal advice and many other services that informal MSEs need in transition and post transition. Following are some of the crucial points in the ecosystem: NGOs, Micro Finance Institutions, Industry Associations, MSME associations, Training and Skill development centers, Business development services, financial institutions and network, State Institutions in the MSME promotional system.

*Role of organizations/NGOs/Associations:* Associations and chambers of commerce of MSMEs can play an important role in facilitating transition of informal sector enterprises into formal world of business. They can provide services like information on registration, support services like tax filing and in facilitating the fulfillment of regulatory requirements.<sup>xi</sup> Associations or organizations of informal sector players can indeed play more effective role in the transition.

*Market Oriented Value Enhancement:* Informal entrepreneurs while are adept in basic business skills, further enhancing and empowering them with market oriented 21st century skills are important. Market Oriented Value Enhancement (MOVE) is an innovative livelihood model developed by Best Practices Foundation (BPF) in 2003-04 upon the realization that most micro-enterprise programmes directed at improving the livelihoods of the poor were ineffective. (Purushothaman, 2012) The MOVE model aims at imparting business concepts and enabling them to establish successful small-scale enterprises. This is 'learning by doing' designed to impart essential skills.

*Market demand oriented entrepreneurship:* Traditional sectors like handicrafts and artisan focused sectors, have very narrow focus. Often they do not think beyond traditional markets. Customer base remain stagnant or recede as the time and technology changes. Often such sectors remain informal and entrepreneurs from such sectors migrate to urban centres due to lack of demand and failure to find sustainable source of income from their traditional business.

*Post loan mentoring support system:* With the Aadhar registration and MUDRA loans scheme and other finance schemes for SMEs access to finance has become easy. However, even after a loan is granted an entrepreneur needs guidance. How to upgrade to new levels of business, regions, new products or technology and markets are all aspects where expert help comes in. Post loan support is often limited. They should get continued mentoring throughout the lifecycle of an enterprise.

To conclude, the sector has a powerful presence of brilliant entrepreneurs, who can potentially contribute much more than what they do today in a formal enterprise space. India needs to tap the potential by way of formalization, modernization and empowerment.

### Notes

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<sup>i</sup> Sustainable development goal no 8 addresses this concern. SDG goals and ILO decent work for all agenda, ILO resolution on transition of informal enterprises into formal ones calls for creating an environment conducive for sustainability at all levels and areas in the life and operations of a business.

<sup>ii</sup> The European Parliament is exploring the possibility of a legislative proposal on an effective traceability mechanism for goods produced through forced and child labour. The Parliament considers that forced labour and child labour need to be taken into account in international trade relations. This could pave the way for a complete ban on the importation into the EU of goods produced through modern forms of slavery or forced labour, especially forced work of vulnerable groups extorted in violation of basic human rights standards.

<sup>iii</sup> According to Article 24 of the Constitution, no child (below 14 years) should be employed in any factory, mine or any hazardous employment. Article 21A of the Constitution also declares that all States should provide free and compulsory education to children between 6 and 14 years of age.

<sup>iv</sup> Waste workers, cycle rickshaw pullers in many of the cities live poor condition in the urban areas, slums and colonies with no sanitation facility.

<sup>v</sup> Companies are increasingly concerned with child labour in their supply chains. They view it as inconsistent with company values, a threat to their image and ability to recruit and retain top employees, as well as to the sustainability of their supply chain. Child labourers can be found in all stages of supply chains, including in agriculture, manufacturing and retail. The Social Dialogue Section of ILO-IPEC supports businesses' efforts to reduce child labour and to increase compliance with the ILO's child labour standards: Convention No. 138 on Minimum Age and Convention No. 182 on Worst Forms of Child Labour.

<sup>vi</sup> Sustainability principles are company's commitment to its stakeholders to conduct business in an economically, socially and environmentally sustainable manner that is transparent and ethical.

<sup>vii</sup> India Pottery Industry, <https://business.mapsofindia.com/india-industry/pottery.html>

<sup>viii</sup> Harpreet Ahluwalia is an entrepreneur and founder of Earthen Creations, Noida. Her work is focused among potters from across India.

<sup>ix</sup> A 2012 study on Rickshaw pullers says in India as on 2011-12 there were around 10 million Rickshaw pullers (Bose, 2012) As of end 2018, the figure stands at 15 million or more according Vignesh Jha of FoRPA, (a representative body of Rickshaw pullers), with presence throughout India there are no exact estimation of their number but it could be anywhere between 15 to 25 million.

<sup>x</sup> Snake charming is illegal as per the Wild Life Protection Act 1972. The use of wild animals is prohibited under this Act.

<sup>xi</sup> MSME associations as well as chambers of commerce operate for the promotion of their member's interest and incurring of additional costs may not often get approval from the members or their boards.

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