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## **Challenges in Transformation of Informal Business Sector towards Formal Business Sector in Nepal: Evidence from Descriptive Cross-Sectional Study**

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### **Authors' contributions**

*This work was carried out in collaboration among all authors. Authors DBA, ND and URP designed the study. Author PG performed the literature search, developed methodology, performed first round data analysis and wrote the first draft of the manuscript. Authors DBA and SP assist PG in the preparation of first draft. Authors ND and URP wrote the second draft of the manuscript. All authors read, finalized and approved the final manuscript.*

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### **ABSTRACT**

This study seeks to contribute to the empirical understanding to the transformation of informal business towards formal business in Nepal on the basis of cross-sectional data. This paper examines the preferences socio-economic and other social capital related to informal business. Various indicators were identified to understand and analyze readiness of various informal sectors from literature review of different theories. People with high level of education less prefer informal sector however, prime working age labor force were involved massively in informal sector. More than two-third respondents argued that situation is not manageable which means the informal economy is not transitional to formal economy. Majority of respondents believes that there are some administrative problems that could hinder the entrepreneurial potential and their creativity to flourish.

**Keywords:** *Informal business; transformation; employment; income; Kathmandu valley.*

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## 1. BACKGROUND

For structuring and managing firms entrepreneurs make strategic decisions in their choices and locations of formal or informal business [1]. A growing stream of research shows that the transition of entrepreneurs from informal to formal market [2]. International trends of trade and investment have a dramatic impact on labor relations and job practices around the world [3,4]. The effect can be detrimental as well as positive, and differs by history, business, commerce, and employment status. Some of those employed in the informal economy were able to find new employment or new markets for their goods [5]. Globalization has brought greater significance in global value chains, while the current global financial and economic crises raises additional challenges in the formal economy to eliminate decent work [6,7,8]. Sharma and Adikari [9] pointed out that informal sector has been a provider of voluntary and involuntary employment and income for a large section of the marginal population in the world.

In this context, informalization is an instance of the emergent diversity of job forms and employment associations arising from the worldwide restructuring of industrial manufacture. Normally, informal economic activities are tiny scale and characterized by low capital endowments, easy technologies, unremunerated family labor, and supple work-sites. When compared, informal and formal economic activities are best understood as social groupings whose industrious activities are subject to varying legal statuses, state intervention, and fabrication relations rather than as dual sectors [10]. In terms of technology, economies of scale, the use of labor intensive processes to produce goods and services, and a virtual absence of well-maintained accounts, the informal economy essentially differs from the formal economy [11]. The informal economy is informal in the sense that it is not regulated by the government, and the likelihood of exploitation is much higher given this lack of state controls [12].

Government of Nepal has never planned the informal part of the economy independently and solely. The issues of the informal economy are discussed on sectorial and thematic lines in general. The Government's current priorities are largely centered on skills and vocational training and the development of micro-finance and micro-credit operations. In reality, very few scheduled welfare services are in place [11]. In this sense,

the government needs to actively promote this sector in which the stakeholders themselves have taken the main initiative so far by providing opportunities for skills training, awareness-raising and other logistical support [13].

There are still many initiatives to be carried out in the development process to sustain the informal economy as-Many of the informal operations are ground-based [14]. Several questions are yet to be addressed in the perspective of informal business sector towards formal business sector in the context of Nepal. The areas like what encourages informal firms to formalize? How does informality shape macroeconomic performance? What is needed and what is possible in support of the global informal workforce? Why has the informal economy continued to expand and grow? Why should the persistence or expansion of the informal economy be of interest or concern? Are still novel. Thus, a proper assessment is required to explore these questions in the context of Nepalese informal business sector towards formal business sector. Therefore, the aim of this paper is to identify informal business sectors readiness towards formal business in Kathmandu Valley.

### 1.1 Literature Review

Stimulating small businesses, even if successfully carried out, will not fix problems of poverty and jobs, but only a small percentage of these challenges will ever become prosperous and profitable [15]. Efficient use of capital given the overall context of job shortages in the industrial economy, the weak purchasing power which characterizes the industry and the organization of output in the informal units; and that although their market share may be expected to decline in the long run, the rate is hard to predict and the pattern may be the reverse in the medium term [16]. Challenges of accessing customers and knowing the "game rules" in dealing with trading partners are key obstacles to development in the private sector [17]. A financing-driven solution to solving the finance dilemma for female entrepreneurs does not tackle the broader and longer-term growth issue of gender-based inequities in loan-lending practices [18].

Analyzing World Bank Enterprise Survey results across 127 countries and accounting for other company output determinants, registered firms that began unregistered and spent longer

unregistered operations are shown to have significantly higher subsequent annual sales, jobs, and growth rates of productivity relative to those registered from the outset [19] illustrating how tax rates and regulatory strategies impact this sector's scale and how the market inevitably decreases as a country moves to a stable state [20]. Financial and business absence' has been rated as the biggest obstacle to keep the business going [21]. The informal sector will tailor outreach efforts to the program specifications to insure that those involved in providing science outreach are properly trained and qualified to do so [22]. Competition between cities has increased with globalization and they are continually failing to draw international investment [23].

It provides clear proof that regional disparities and similarities are significant in understanding the nature of the formal and informal sectors [24] which helps to measure the possible flows into the workplace, particularly from the education system, the potential growth of formal pay jobs in urban areas, and the current size and composition of the informal sector [25]. In contrast to economic recovery owing to the macroeconomic stability policy implemented in 1991, the comparative benefits of staying in the formal sector have increased significantly and the relative costs of becoming or keeping in the informal sector have also increased [26]. Williams et al. [19] stated that licensed businesses that initially resist registration costs and concentrate their energy on addressing certain current obligations build a stronger foundation for subsequent development, build more lucrative incentives not only by reshaping business, but also by allowing illicit enterprises to circumvent regulation by encouraging the efforts of entrepreneurs to maximize such opportunities [27], increasing entrepreneurship education and training can also increase awareness of the advantages of formality [18].

Though several studies were conducted in this matter earlier some limitations can be witnessed. Steer & Sen [17] analyzed informal structures in the early stages of the transformation in Vietnam, when the private sector was still very limited and the object of much political animosity, and the institutional structure was not yet fully developed. While it is shown that formal companies avoiding registration and spending longer unregistered outperform those registered from the start of operations substantially, there are also limits to what can be inferred and precautions needed

[19]. Lack of credit for female entrepreneurs in Indonesia is a top concern as it is in other countries [18]. A clear stagnation of the size of the modern sector in francophone Africa is observed over time [28] Countries plagued by corruption are hampering business activity, at least in the formal sector, which has an effect on economic growth and development, especially among developing and transition countries [29].

The literature shows how formal and informal business sectors are practiced in various parts of world and how they are trying to formalize the informal business sectors. Various theories reviewed helped to understand and analyze readiness of various informal sectors of different part of world to formal sector. However, readiness of informal business sector to formal business sector is still unknown. Hence this paper will help to reveal readiness of informal business to move towards formal sector helping businesses to make further strategies, policies accordingly.

## 2. METHODS

In the urban context of Nepal, the informal sector refers to small enterprise operators selling goods and services and thereby involving the cash economy without official registration [30]. To measure the informal sector activities, various methods have been in practice, no single method can compute all the informal sector activities simultaneously. In case of Nepal, Labour Force Survey has used household survey method to collect the information of the informal sector.

### 2.1 Study Area, Sampling Method and Data Collection

This study uses both descriptive and explanatory design with primary data. Basic research method like survey, interview, and questionnaire were practiced. The structured questionnaire has been used to collect data. For many informal micro-entrepreneurs, Kathmandu valley has become a land of opportunity. So, Kathmandu valley was chosen as the area of study which included three districts i.e. Kathmandu, Bhaktapur and Lalitpur. The Key informant interview (KII) was facilitated to understand whether the current research has covered informal sector issues in Kathmandu Valley.

The street vendors alone register in the Kathmandu Valley about 30,000 [30] (about 3 percent of the economically active population). Nepal's Central Bureau of Statistics (CBS)

regular data collection system does not cover the informal sector that consists of households with at least some market output. The informal sector details were revised with the data collected through the Nepal Labor Force Survey of 2008. The NLFS 2008 reports that the informal sector hires more than 11 million people aged 15 years and older, with a share of around 96.2 percent of the total workforce.

To meet the objective of the study stratified random sampling was used. The population for this study is the entire Informal sector entrepreneurs in Kathmandu valley with at least one employee and the owner/manager engaged in manufacturing/processing, services and retail sectors. Structured questionnaire with the help of various tools were developed in order to gather the information. If the population is unknown or  $> 10,000$ , the sample size can be derived by computing following formula [31].

$$n = Z^2 pq/d^2$$

Where,  $n$  = sample size required for study, standard tabulated value for 5% level of significance =  $z$ ,  $p$  = Prevalence of customer awareness on banking communication,  $q = 1-p$  and  $d$  = degree of accuracy, usually set at 0.05 level. With the help of formula we calculate total 384.16 ( $\approx 384$ ) respondents are required to address the issue in correct form. We also take 5% non-response error to minimized non-response problem which is 20 people. With all this calculation, finally the sample size taken for study was  $(384.16+19.208) = 403.368(\approx 403)$ . This study is solely based on descriptive data analysis.

### 3. RESULTS AND DISCUSSION

#### 3.1 Socio-Demographic Analysis

##### 3.1.1 Age, sex and marital status of respondents

This study observed that maximum numbers of respondent was from 20-29 years of age group that is 41%. Similarly other age group involved in informal sector is 30-39 years (27%) and 40-49 years (14%). It indicates that lack of formal job, people of prime age labor force are involved massively in informal sector. Our findings depicts that in the study area, informal business is male dominated.

The percentage of unmarried respondents is 30 percent and married is 70 percent. This shows that married respondents are in majority and

double than that of unmarried respondents which shows minority of unmarried respondents. Also, other study suggests that the involvement of married ones in informal business is not a good message because if their business gets collapsed, closed, due to changes in government policy, municipal rules, expansion of roads and removal of informal business, other pressure, etc. then they will be unable to earn which means their family, child education, health condition and living standard will get affected [32].

#### 3.2 Education

Education is very crucial in enhancing knowledge of people. In the field of education, people in the informal sector are characterized by low levels of formal schooling, high drop-out rates from school and lack of access to tertiary education. About 15 percent respondents haven't study and 28 percent respondents have done primary education (Table 1). More than one-third (37percent) respondents, who have studied up to secondary level. The respondents who have studied up to higher secondary are 15 percent and only 5 percent respondents were in university education. It indicates people with high level of education less prefer informal sector. The finding shows that more respondents were from secondary level education. Secondary level education is not enough for mature thinking and strong business activities [33]. Because higher the education level, higher will be thinking capacity and business development and promotion. Thus, to control or manage informal sector, promotion of education is vital [34]. Several other studies [35], also revealed that education can play determinant role to manage informal sector.

#### 3.3 Occupation

Major occupations in the informal sector include home-based workers (such as dependent subcontract workers, independent own account producers, and unpaid workers in family businesses) and street vendors, which both are classified in the informal sector [36].

The majority of respondent were found involving in informal business and informal services activities they were 225 and 169 out of 400 respondents respectively. Only few respondents was found engaged in other activities. This dispersion is due to financial shortage and resource inadequacy. Most of them involved in informal sector already have their own business and service [37].

**Table 1. Socio-demographic character of respondents**

Variables	Number	Percentage
Age		
Below 20	47	11.75
20-29	165	41.25
30-39	107	26.75
40-49	55	13.75
50-59	21	5.25
Above 60	5	1.25
Gender		
Male	315	78.75
Female	85	21.25
Marital Status		
Married	279	69.75
Unmarried	121	30.25
Education		
None	59	14.75
Primary	112	28
Secondary	149	37.25
Higher secondary	60	15
Bachelor's	19	4.75
Master's	1	0.25
Occupation		
Agriculture	1	0.25
Business	225	56.25
Industrial worker's	1	0.25
Service	4	1
Others	169	42.25
Income (Monthly)		
Below 20000	84	21
20001-30000	142	35.5
30001-40000	95	23.75
40001-50000	59	14.75
50001-60000	14	3.5
Above 60000	6	1.50
Work Experience		
Below 5 year	160	40
5-10 years	116	29
10-15 years	60	15
15-20 years	44	11
20 years above	20	5

Source: *Field Study*

### 3.4 Income

Income is money what an individual or business receives in exchange for providing labor, producing a good or service, or through investing capital [38]. Individuals most often earn income through wages or salary. Businesses earn income from selling goods or services above their cost of production. Table 1 also shows that monthly income of the respondents, depend on occupation and there experience, which helps to generate cash, but not whole revenue how much they consume. The

result presents that the income of the individuals varies from person to person as per their works and involvement. Their income shows the individuals earning capacity to run their families. The majority, more than one-third (35.5 percent) of the respondents are earns in between NRs. 20000-29000. Also the minority of the respondents are 5 percent who earns above NRs. 50,000. Similarly, there are 21percent respondents who earns below NRs. 20000. 23.75 percent respondents are earning in between NRs. 30000 to 39000. 14.75 percent are earning in between NRs. 40000 to 49000. In

this way, their earnings vary their standard of living. Their income is in vulnerable state which is not sufficient enough for them. That means just to survive they are being involved in this sector. Several other studies [39] show that their life is not at income sufficiency level.

### 3.5 Working Experience

Working experience is basically the knowledge gain from working in a particular field for a particular time period. The more, people invest their time in an organization, the more they gain work experience which also create sense of loyalty, trust, honesty and commitment (Vance, 2006). Its period of time that a young person spends working with an employer as a form of training and experience.

We can observe from the table that there are altogether 40 percent respondents who have invested less than 5 years in a particular business. Similarly 29 percent respondents are having experience of 5 to 10 years, 15 percent are having 10 to 15 and 11 percent having experience of 15 to 20 percent. And the minorities of respondents who are having work experience of above 20 years. Those who work for long time automatically left informal sector. They seem involved in informal sector just for their livelihood in short run. In long run they are not much interested in such sector.

#### 3.5.1 Challenges/ obstacles faced by informal business sector

However we have found that workers has been facing many challenges regarding informal business which signifies that such informal sector business has been taking into considerations every things that could create barriers in transition of informal to formal business flourish economy. However respondents have expressed their views regarding the administrative problems so as to formalize economy. Their response is in the form of Yes/No questions, where 1=yes, 2=no (See Fig.1).

Fig. 1 displays that 86% of respondents believes that there are some administrative problems that could hinder the entrepreneurial potential and their creativity to flourish. And only 14% of them do not find any administrative barriers in transition of informal economy to formal economy.

As per the respondents who have been facing challenges, there are lots of obstacles like

uncertainty about the future, financial crisis, monitoring performance, open competition, high risk, global market, global competition, technology, lack of direction/vision, inadequate resources, etc. that needs to be minimized and solved through government support, registration, insurance, labor act, legal policy, and implementing strict employment legislation and act.

Fig. 3 shows that there are only 34 respondents who agrees that there is adequate labor legislation and protection whereas 366 respondents does not agree. 349 respondents says that there is not sufficient infrastructure there are sufficient infrastructure. Also, 354 respondents agrees yes while the rest 46 disagree about the over crowdedness and competition. Similarly, 360 respondents think that there exist entry barriers whereas 40 respondents do not think so.

#### 3.5.2 Managerial solution for transformation of informal business sector towards formal business sector

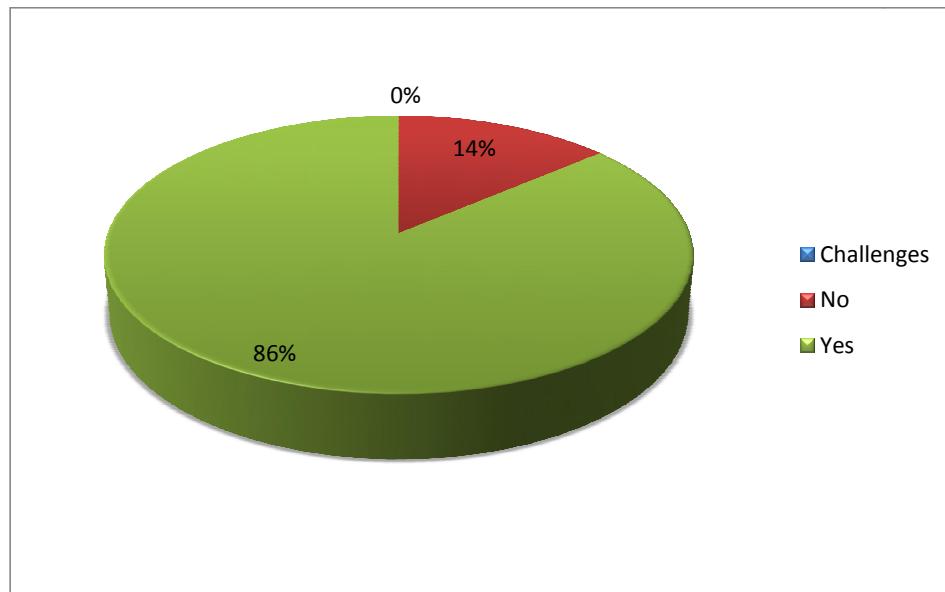
To recommend potential managerial solutions for transformation of informal business sector towards formal business sector in Kathmandu valley is the final objective of the study. There might be several managerial solutions so as to eliminate the barriers in transition of informal economy to formal economy. This section deals with recommending potential solutions for economy transformation [40]. The informal economy is contributing positively to the social and economic development of individuals [41]. Their involvement in the informal economy has empowered them to become economically independent, respected in their communities and have more self-respect, self-confidence and an enhanced self-esteem [42]. The informal economy also affords women the opportunity to develop and enhance their skills [43]. Business management skills and entrepreneurial skills were lacking in the management of the small enterprises [44].

However respondents have expressed their views regarding the transitions of informal economy to formal economy. Their response is in the form of Yes/No questions, where 1=yes, 0=no (See Fig. 3).

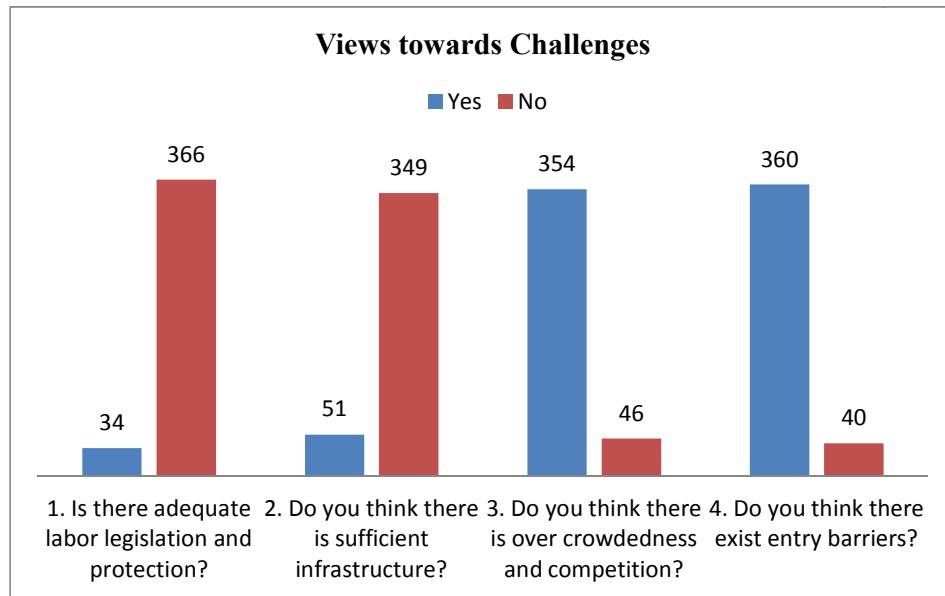
The figure depicts that there are 66 percent of respondents who said that situation is not manageable which means the informal economy

is not transitional to formal economy. And 34 percent of respondents said that the situation is manageable which means transitional. However the people who said yes have mentioned some management strategies such as vocational training and development should be formalized, insurance, security maintenance, legal policy, etc. should be carried [45]. Similarly,

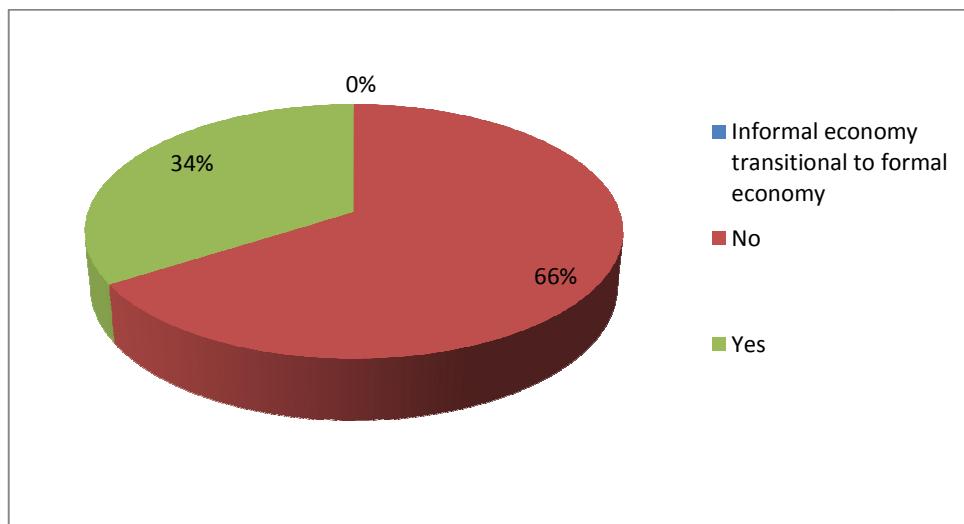
government, owners, employees, investors, shareholders are the main responsible for managing informal economy [46]. Also, who said no have mentioned the reason behind it such as lack of strict labor legislation and act, improper government regulation, illiteracy, lack of knowledge, poor management [47].



**Fig. 1. Administrative problem**  
Source: Field Study



**Fig. 2. Respondents views on challenges**  
Source: Field Study



**Fig. 3. Informal economy transitional to formal economy**

Source: Field Study

Though the informal economy has become an alternative, people, especially women engaged in it face many challenges. The literature, Becker [48], Canagarajah and Sethiraman [49] emphasized that the informal economy lacks recognition, is not legally and socially protected, lacks representation and health and occupational safety measures [50,51].

There are a few entry barriers to the informal economy and this has resulted in competition among those involved [52,53]. Competition affects business in that it results in the high supply of goods/services and this keeps the income low [54]. Resources are not accessible to most people and more so for women in the informal economy [55,56]. Not only are they inaccessible there is also a lack of awareness of the availability of such resources [57,58]. There is lack of capital for investment in the enterprises; thus businesses are neither growing nor progressing [7,59].

Registration of enterprises in the informal economy should be made easier by the government and the municipality [60]. People should be informed and educated about the registration process and incentives for registration should be developed to encourage people to register their informal businesses [61,62]. In most of the developing countries women make up large section of informal business and microfinance involves to provide credit [45]. The municipality should establish business premises where small enterprises can

operate and rent at cheaper costs [63]. Government, local municipality and non-governmental organizations should work in partnerships to offer skills development and training in business management and entrepreneurial skills as well as other skills to develop the human capital of women headed households [64].

#### 4. CONCLUSION

Informal business usually run by people unemployed in the formal sector of the economy. Government of Nepal has never planned the informal part of the economy independently and solely. This paper seeks to analyze socio-economic behavior of informal business and informal business sectors readiness towards formal business in Kathmandu Valley. The analysis of the informal business of Kathmandu valley using cross sectional data shows that lack of formal job, people of prime working age labor force are involved massively in informal sector.

About 15 percent respondents haven't study and more than one-third respondents, who have studied up to secondary level. It indicates people with high level of education less prefer informal sector. The income of the individuals varies from person to person as per their works and involvement. Their income shows the individuals earning capacity to run their families. The majority, more than one-third of the respondents are earns in between NRs. 20000-29000. Their income is in vulnerable state which is not

sufficient enough for them. That means just to survive they are being involved in this sector. Around 40 percent respondents who have invested less than 5 years in a particular business. Those who work for long time automatically left informal sector. In long run they are not much interested in such sector.

The study found that more than two-third of respondents who said that situation is not manageable which means the informal economy is not transitional to formal economy. Many workers has been facing many challenges regarding informal business which signifies that such informal sector business has been taking into considerations every things that could create barriers in transition of informal to formal business flourish economy. Around 86 percent of respondents believes that there are some administrative problems that could hinder the entrepreneurial potential and their creativity to flourish. And only minority of them do not find any administrative barriers in transition of informal economy to formal economy.

## COMPETING INTERESTS

Authors have declared that no competing interests exist.

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