

WHAT IS THE VALUE OF (IN)FORMALITY FOR MSEs?

A case study on MSEs in the Nairobi CBD

THE CONTEXT

In Kenya, MSEs account for:



With an estimated **83%** of the total labour force working in the **informal sector**



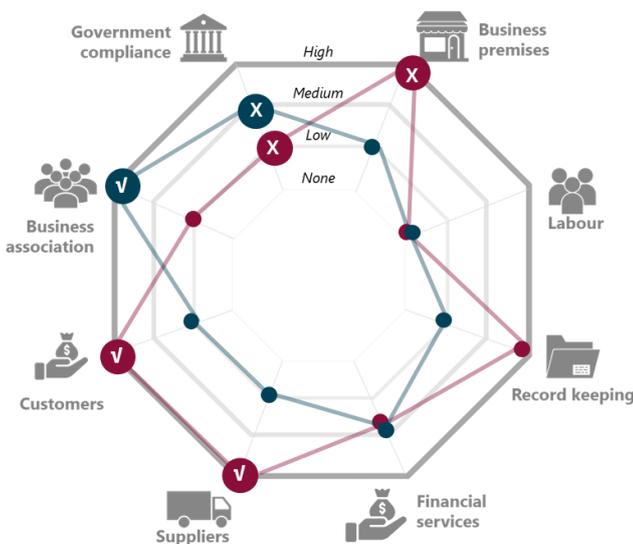
STUDY OVERVIEW

Source: FSD Kenya, State Department for Industrialization

In Kenya, the terms *informality* and *MSEs* (micro and small enterprises) have almost become synonymous. But, is this true? Are all MSEs informal? **What constitutes formality and informality and what are the underlying drivers and incentives that determine how MSEs operate?** This research was set up to investigate these questions with a focus on MSEs operating in the Nairobi CBD.

Using a mixed-method approach including qualitative deep-dives with business owners, the study found that MSEs are **extensively using both formal and informal relationships** across different aspects of their business, as captured in the multi-dimensional framework below. But perhaps the most central finding of this research is that **three factors determine where MSEs sit on the spectrum of (in)formality**, these include: **coercion (force)**, **lack of choice/alternative**, and most critically, the **perceived value** of the relationship.

It is with this in mind that this research hopes to provide new insights on the **opportunities and challenges to increase value for MSEs in Kenya** and to support the development of a more enabling environment for **business resilience and growth**.



MAPPING FORMAL & INFORMAL RELATIONSHIPS: CASE STUDY OF A VEGETABLE TRADER

Selected dimensions:

- » **Government compliance:** Market fees & produce Cess amount to high annual cost for business
- » **Premises:** Temporary space in market. Lack of security of tenure suppresses ability to make long term plans, extracting value from business
- » **Business association:** Registered member, derives value from group bargaining power
- » **Customers:** Very close, long-standing relationships, invaluable to business

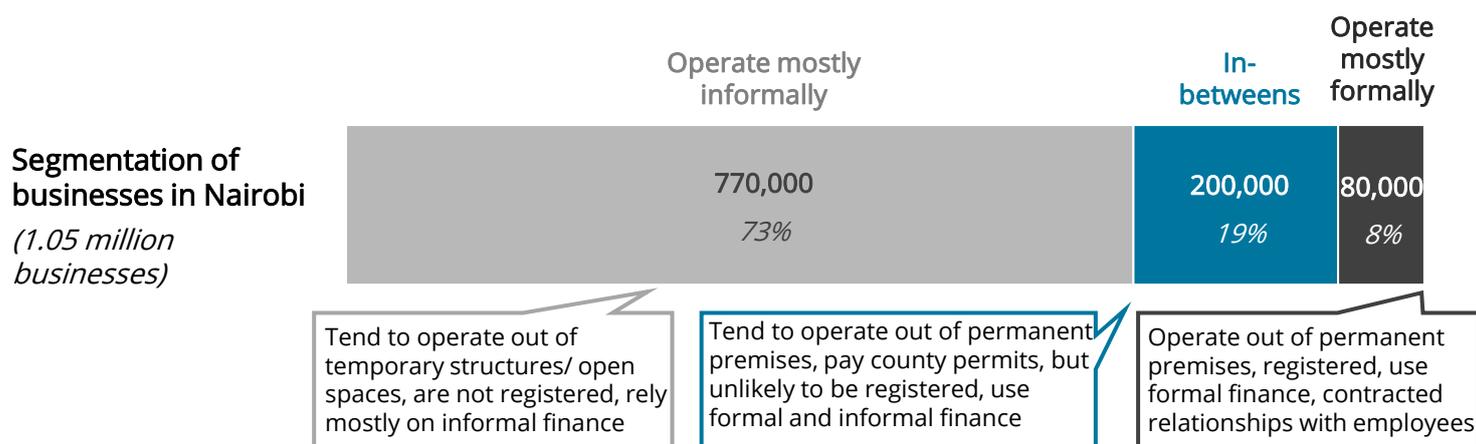
KEY
Blue line - formal relationships ✓ - relationships that **add value**
Red line - informal relationships X - relationships that **extract value**

1 | This study was conducted by 71point4 and Gmaurich Insights on behalf of FSD Kenya and the SME Advisory



SECTOR SIZE AND SEGMENTS

Ninety-six per cent of businesses in Nairobi (1 million businesses) are classified as 'micro' enterprises (have less than 10 employees), and almost three quarters of businesses operate 'mostly informally'; often out of temporary premises and with no business registration.



Source: KNBS MSME 2016 survey data

KEY INSIGHTS

MSEs invest heavily in cultivating and managing informal relationships

These investments have paid off and add substantial value to business operations

- Relationships with **suppliers** yield reliable service and **working capital**, vital to business success
- Relationships with **customers** creates loyal and **dependable demand**
- Relationships with **employees** supports business continuity, and **promotes skills** and capacity building, especially for rural migrants and youth
- Relationships with **informal financiers** provide crucial **access to capital** tailored to the needs and challenges that businesses face

However, reliance on informal relationships has significant limitations

- It can undermine an MSE's ability to do business by **limiting access to markets**, supply chains, infrastructure, services, financing and recourse
- This compromises the willingness and ability to effectively invest in business growth

COVID-19 has revealed the vulnerability of informal institutions when faced with large scale shocks

- Carefully cultivated relationships and trust have been damaged by the inability to meet financial and other obligations

Some MSEs are formalizing on specific dimensions

For some MSEs, investing in formalizing their businesses has yielded value

- MSEs which have registered have found that this has opened up **new market opportunities**
- Digital payments **create visibility** of cashflows which provide business intelligence and better access to formal finance
- Formal financial institutions including banks, and Saccos provide a **valued source of funding** for growth and expansion

However, the majority of MSEs find formalization, specifically with regards to government compliance, extractive

- Formalization can have **significant cost implications**; fees for permits are compounded by additional taxes such as Cess, amounting, in some cases, to over KSh 60,000 per annum
- Compounding this is money spent on bribes to officials and monies paid for services which are not adequately delivered (e.g. sanitation)
- Many MSEs **do not feel they receive value from formalization** as it provides little in the way of access to services, capital or markets

RECOMMENDATIONS

MSEs gain value from both informal and formal operations, however, both present challenges. To promote growth and resilience in the sector, interventions should attempt to preserve the best of the informal, whilst encouraging MSEs to invest in formalisation by making this an attractive, value-adding element of business operations. Some key recommendations to increase value for MSEs are included below.



Partnerships are key

A large number of public and private stakeholders are involved in the MSE sector, but there is limited coordination between them

- Create an MSE working group to enhance communication and coordination between entities, improve data sharing, and encourage collaboration on key issues facing the sector



Better data and data sharing practices are needed

Data on the sector is fragmented, infrequently updated, often in-accessible and data quality is variable

- Review available data and data collection practices to identify data gaps
- Develop a data plan to fill gaps and improve data collection, as well as data sharing practices



Link formalization with value creation

Efforts to improve formality should be based on corresponding investments in value creation for MSEs

- Clearly demonstrate how money collected from MSEs is utilized for their benefit, such as the provision of basic services, improved market areas, provision of funding, etc.



There are multiple opportunities for digital technology

Digital technology can be leveraged to increase visibility and transparency in sector and can also create linkages in the sector to drive efficiencies and growth

- Digitise B2G payments and encourage businesses to accept digital payments
- Develop online platforms to link MSEs to new markets, suppliers, funding opportunities and provide access to information



Leverage business associations to engage with MSEs

Business associations interact with a large number of MSEs and so provide a useful channel through which to communicate information on government tenders, financing opportunities, market development plans, and other opportunities

- Monitor associations closely to ensure good governance and provide MSEs with safe mechanisms to lodge complaints and grievances against associations without fear of repercussion



Provide support in response to COVID-19

COVID-19 has had, and continues to have, a significant negative impact on MSEs

- Ensure all market areas and worksites are COVID-19 compliant
- Review penalties for non-compliance with permits and missed payments for the NHIF
- Provide funding through the proposed MSE fund and other funding sources to affected MSEs

PERSONAS

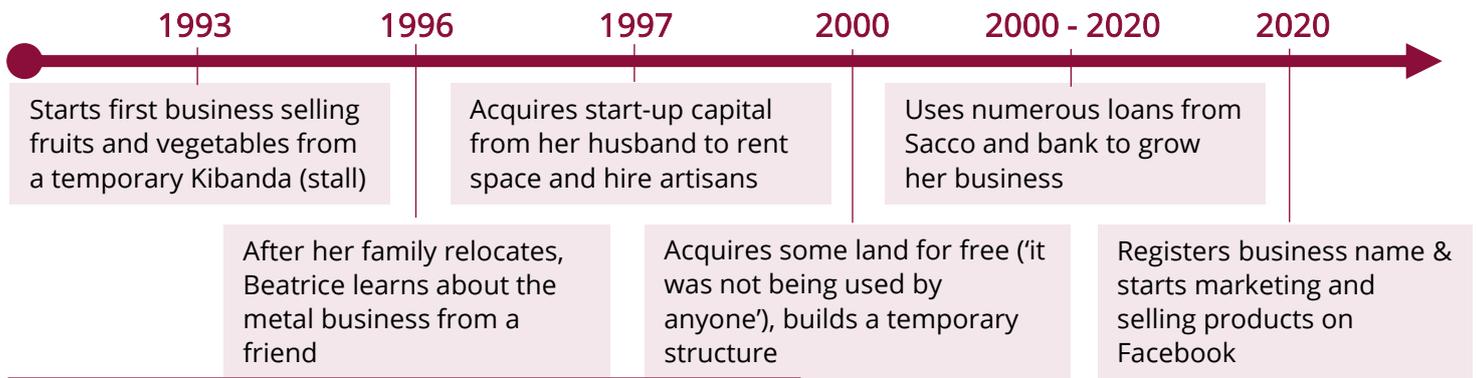
A number of personas were developed based on interviews with business owners. One example is shown on the next page



BEATRICE – Metal fabrication

Beatrice is 53 years old. She has been operating a metal fabrication business in Kamukunji since 1997. Her main challenges include material shortages which increase prices and the high level of competition in the sector.

JOURNEY TO THE CBD



OPERATIONS

Government compliance

Does not make any payments to County. Recently registered her business name in response to a tender requirement, has realised value from this. Files personal tax returns annually

“Since I registered my business name and advertised it on my Facebook page, I've been getting so many inquiries from companies and businesspeople

Premises

Operates within a Jua Kali worksite out of numerous temporary structures she built over time. She did not pay for the land; it is unclear who the original landowner was

Labour

Employs two full time employees and between two and four artisans. She has no employment contracts, relationships are based on trust and traceability

“My employees are from my homeland, these are people I am familiar with and in case of any problem, I can trace them back to their parents' home

Records

Keeps handwritten records on sales and expenses. Her husband moves her records onto a computer. She has used these records to access finance for her business

Financial services

She has a personal bank account and has accessed numerous loans from her Sacco and Bank to grow her business. However, she has stopped accessing formal finance because she is only offered group loans which pose a risk to her business. Her merry-go-round has ceased operations due to COVID-19 so recently she has relied on loans from her husband but it is unclear how his support will be affected by COVID-19

Suppliers

Uses suppliers that are members of the Jua Kali Association. Has close, trust-based relationships with certain suppliers, some of which allow her to purchase goods on credit

Customers

Customers include individuals and businesses. She has built close relationships with her main customers and relies on verbal agreements. Her daughter assists with her with marketing products on Facebook to attract new customers

Collectives

Registered member of the Jua Kali Association (pays monthly membership fee). Sees numerous benefits including access to tenders, dispute resolution and welfare support. But worries that government support does not trickle down to businesspeople