

Informal entrepreneurship or “survivalship” ?

Results of an empirical study among self-employed, micro and small businesses in Georgia

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Abstract

The aim of this article is to examine the linkages between informality and entrepreneurship using a dataset on self-employed, micro and small enterprises in Georgia. It examines how the different dimensions of entrepreneurship influence the transformation of informal entrepreneurs into formal, which is a debate of major importance for transition and developing economies. It shows first the grey areas between informality and formality in the path to full formal entrepreneurship. Micro enterprises, which are supposed to belong to the formal economy, share some common characteristics with self-employed, typical of informal sector activities. Business registration and the holding of accounting records are therefore only partial indicators of enterprises' formal organization and are not the only “exit doors” out of informality. Second it shows that the majority self-employment and micro-enterprises are simply surviving and did not evolve to micro firms and micro firms did not grow to small enterprises. This has significant implication with regards to the potential of the informal sector for the formal one and the study of entrepreneurship in transition countries.

Acknowledgment

This research was supported by the Gebert Rűf Stiftung . We thank our colleagues Prof. Hayoz N. and Dr. Dafflon D. from the Academic Swiss Caucasus Net without who also provided essential for the conduct of this research. We also thank Prof. Karrar H. and Dr. Fehling S. for the precious review of this paper.

Introduction

The integration of informal economic activities into the formal economy is an important part of the “transition” process of former communist countries and one of the biggest challenges of building a market economy from scratch (Freeland, 2000). But the language of reform tends to mask the difficulty of such a process and prevents one to recognize that market economies in former Soviet countries needed to be created and not simply fixed. “Transitioning” to a market economy is not a smooth and linear process, as actors tend to rely on old routines in the face of increasing uncertainty. The waves of privatization should be considered in this light because privatization is more than the simple transfer of ownership from state-owned enterprises to private ones (Zahra et al., 2000). Transitioning to a market economy, Actors tend to rely on old routines in the face of increasing uncertainty, which makes “transition” a non-linear process. The structure of incentives within which entrepreneurs in transition evolve is influenced by mismatches between supply and demand and restructuring of formerly planned economies, creating a wide range of opportunities. On top of that the rapid changes and fragile institutions oblige entrepreneurs to cope with high level of uncertainty (Aidis and Estrin, 2006:5). By the same token, the phenomenon of entrepreneurship, without which privatization would be meaningless, must also be considered in this context of “transition”.

This “transition” from planned to market economies centered around the development of the private sector rests therefore also on the transformation of informal entrepreneurs into formal ones. Although the size of the informal economy is difficult to measure accurately, a recent study released by the International Monetary Fund (IMF) estimates it between 26 percent of GDP in Kyrgyzstan, 35 percent of GDP in Armenia, 33 percent of GDP in Kazakhstan, 32.8 percent of GDP in Tajikistan, 31.5 percent of GDP in Azerbaijan and 30.1 percent of GDP in Georgia (Abdih and Medina, 2013). Indeed, more than 50 percent of the labor force in Georgia is considered as being self-employed and informal and contributes approximately 20 percent of GDP.¹ The drastic reforms that followed the rose revolution did not manage to integrate better the informal sector into the formal one. Taxes and procedures have been reduced and streamlined without increasing the level of tax compliance of the self-employed (Torosyan and Filer, 2014). There is very little mobility between different status of economic occupation (Bernabè and Stampini, 2009), which is an indication of a segmented labor market.

Georgia’s informal economy is not covered by business statistical instruments but only by the social department of statistics: the persons active in this unobserved part of Georgia’s economy, from a

¹ According to Geostat and own calculation

statistical point of view, are defined as “self-employed”. Little is known about the mode of activity of self-employed except that they live mainly in rural areas and that some may de facto run micro-enterprises. Yet self-employment amounts to about 2/3 of the total employment and according to the author estimates generates about 18 percent of GDP. In other terms, this part of the population has a very low level of income per head.

The article uses the data of a research project whose objective was to examine if and how self-employed and micro-firms in Georgia (of which the informal sector is mostly made of) evolve into small firms. It studied the transition from entrepreneurship by default to entrepreneurship by choice and opportunity over two years’ time. The first section of this article details the definitions used for entrepreneurship as well as the methodology of the study. Section two gives some basic information about the population surveyed. Section three presents the formal/informal dimension of entrepreneurship for the different cohorts of enterprises surveyed. It shows the grey areas between informality and formality in the path to full formal entrepreneurship. Micro enterprises, which are supposed to belong to the formal economy, share some common characteristics with self-employed and these are typical of informal sector activities. It gives an indication about the degree of formality of the diverse entities surveyed from the point of view of their organization. Most importantly, it shows that between 2013 and 2015 the degree of formality has not changed. In fact, it has actually slightly decreased among micro enterprises.

This, in spite of a business friendly regulatory environment, the lowest level of corruption in the region, low level of taxation, the establishment of one-stop shops registration points and streamlined administrative procedures. The liberal reforms of the Rose revolution and their implementation by the Saakashvili administration are considered as examples of liberal economic reforms by the rulebook, that is why the informal sector should have retrieved in the light of efficient economic institutions (Schneider, Buehn & Montenegro 2010).

Entrepreneurship and the informal economy: definition and approach

Entrepreneurship is a multidimensional phenomenon (Dembinski, 2006) that is difficult to capture with a single definition. The development of entrepreneurship comprises many factors: demographic, technological, industrial and economic. Government intervention and culture can also shape entrepreneurial activity (Verheul et al., 2001). To complicate things further, entrepreneurship in emerging and transition countries appears to be different. The incentive structure in which entrepreneurs in transition evolve implies rapid change and extreme uncertainty, restructuring, weak market institutions and numerous informal rules and norms inherited from the previous regime.

Different commitment to growth can distinguish between “proprietors” and “business owner”, or between those who are entrepreneurs by default, to survive, or those who are entrepreneurs by opportunity (Estrin et al., 2005).

Entrepreneurship in this article implies “*processes of discovery, evaluation and exploitation of opportunities*” (Shane and Venkataraman, 2000, p. 218). It supposes the establishment of an organizational unit, which can be a legal entity or not and supposes as well that the discovery and exploitation of opportunity is influenced by the institutional framework in which entrepreneurs are embedded.

From this point of view, the enterprise is actually the result of a process of entrepreneurship, and not the beginning of it. In other words, reducing the number of days needed to register a company might facilitate the registration procedure, but does nothing to form “entrepreneurship” per se. Secondly, it places both the enterprise and the process of entrepreneurship in their post-communist social economic environment, in which network and inter-personal relations are important. Parallel circuits, *blat*² and networks are entrepreneurial responses to the shortages of centrally planned economies and part of the resources available to entrepreneurs (Smallbone and Welter, 2001). This conception of entrepreneurship is therefore also well adapted to the study of informal sectors. In fact, these dimensions of entrepreneurship overlap with the two dimensions of informality identified by Guha-Khasnobis, Kanbur and Ostrom (Guha-Khasnobis et al., 2006), namely, the degree of structuring of enterprises and the reach of official governance. The first dimension relates to the organization of an activity and the predictability of the framework according to which individuals in the organization act. The second dimension relates to the interaction of this organization with the structure of official governance.

A longitudinal study consisting in 4 surveys of the same panel of 250 self-employed, 150 micros and 100 small firms was conducted in three regions of Georgia (Tbilisi, Kakheti and Adjara). Longitudinal studies try to establish the sequences of a process, thus suitable to the study of entrepreneurship (Rajulton, 2001).

The Ministry of Finance of Georgia, which edict the Georgian tax code, recognize micro-business as those with an annual turnover below GEL 30’000 (approx. 18’000 USD) and small business as those with less than GEL 100’000 (approx. USD 60’000) of annual turnover. It has no definition of medium firms. For GeoStat, the national statistical office, small firms are those that employ less than 20 persons with an annual turnover of less than GEL 500’000 (approx. USD 300 000). Medium enterprises are those with less 100 persons generating a turnover of less than GEL

² A system of informal contacts and personal network (Ledeneva, 1998)

1'500'000 (approx. USD 900'000). So to form the sampling frame for micro entrepreneurs, the database received from the Revenue Service (Tax Office) as used. Internal sources of the Georgian Statistical Agency were used to form the sampling frame for small enterprises. The sampling frame for self-employed was formed on the basis of the household survey results. A Stratified Random Sampling method was used for the survey study. Sampling was made for the first round and selected respondents participated in all rounds. Strictly speaking, the sample is only representative of the enterprise population in the region of Kakheti, Adjara and Tbilisi.

A glance at Georgian self-employed and micro-entrepreneurs

The overwhelming majority of the self-employed interviewed are active in agriculture, reflecting the structure of the Georgian economy (60 percent of the respondents are living from agricultural activities). This is a “by default” activity for a majority of Georgians. Only 8 percent of the self-employed surveyed are active in trading and 4 percent of them get revenue from manufacturing and construction. 30 percent are active in “services” which comprises activities such private household employing staff, education, transport and communication. The individual farmers interviewed by this study constitute the overwhelming majority in Adjara and Kakheti, where they represent 50 and 70 percent respectively. On the other hand, 90 percent self-employed interviewed in Tbilisi are active in services and trading. Unsurprisingly entrepreneurship by default is the major type of entrepreneurship in Georgia. Indeed, 67 percent of self-employed state that they started their activities since there was nothing else to do. Agriculture is then the default activity of “default entrepreneurs”.

If agriculture seems to be the default activity for the self-employed in Georgia, micro and small firms surveyed show a more diverse picture. 20 percent of them are active in manufacture, 38 percent are traders and 40 percent of them are in the service sector, which includes transport and communication, education and private household employing domestic staff. It is difficult to identify one single category of motivations of micro and small firms for doing what they do. The “entrepreneurship by default” is still a prevalent answer, but, contrary to the self-employed, it is mixed with desires to make more money (a question which obtain the same number of answers). However, taking advantage of possible opportunities is still not a very common response. Micro and small firms do not believe that there has been positive changes over the past 2 years; more than 70 percent say that the situation is not better as compared to summer 2013. 70 percent of the micro and small firms earn less than 30'000 GEL of turnover per year, which corresponds more or less to 1500 USD per month. By the same token, 70 percent of micro and small firms do not reinvest some of

their revenue into their businesses. Unsurprisingly earning more increases the likelihood of reinvesting as table 1 below shows.

Table 1: Turnover per year of survey micro and small enterprises (first round)

Percentage of those who reinvest	less than 30'000 GEL (approx.: 13'000 USD)	30'000 GEL - 100'000 GEL (13'000 - 45'000 USD)	Above 100'000 GEL (above 45'000 USD)
	25	33	50

While the majority of self-employed are “necessity driven entrepreneurs” at all age, the oldest segment of this study clearly differentiate itself from the youngest one when it comes motivations, confidence and attitude to risks. There is a higher percentage of younger self-employed who plan to sell more the next 6 months to 2 years. By the same token, 74 percent of the self-employed below 39 would be ready to follow training courses to improve their business, while only 20 percent of those above 60 would agree to do so. Similarly, 57 percent of those below 39 are willing to take more financial risk for a chance to produce more. Only 14 percent of those above 60 would take that risk. Half of the self-employed below 39 feel confident to start another activity with the skills they have, against 32 percent of those above 60. By the same token, fear of failure would prevent 39 percent of the young self-employed to start another activity, while it would prevent 60 percent of the old ones.

Informality does not end at keeping accounting

The degree of formalization of Georgian self-employed, micro and small enterprises can then be captured using the answers to a set of 4 questions:

- Do you hold an accounting record?
- At this time, do you have a bank account?
- Do you operate with contract and written terms of agreements?
- What the type of persons do you have been listening to for advices?

Bank account, accounting records, operation with written terms of agreements are indicators of a formal way to organize one's enterprise. It shows entrepreneurs willingness to benefit from formal institutions such as bank, accounting rules and commercial law. Less obvious and perhaps more disputable is the last question. Many different people can give advices on how to run a business (parents and/or other family relatives, a former boss, contact living abroad, etc). The following

answers were deemed to indicate a certain degree of formality in the organization of a business: possible investors, banks, development agencies, public services advising business, clients. It is possible to establish informal relationships with persons working for formal institutions, which is why such a question can introduce a bias. Nonetheless, if an entrepreneur's network includes a formal institution which is used as a source of information and advice, it was considered as reflecting a formal organization. A positive answer to the first three questions would increase the degree of formality by one point. Including one of the "formal sources of advices" cited above to the fourth question would also add one point.

In our study, obtaining two points or more over 4 indicates a high degree of formalization. This wide angle used to look at the organization of the economic activity of the self-employed allows to see that the overwhelming majority of self-employed have a very low level of formality. Indeed, only 3 percent of the self-employed obtained a high degree of formalization. So not only formality cannot be defined by business registration, but it cannot even be reduced to keeping accounting records. What is more, only 20 percent of the micro firms interviewed show a high degree of formalization and this is mostly due to the fact that micro firms have legal obligation to keep accounting records.

Indeed, micro enterprises, which are made up of individual entrepreneurs registered as micro enterprises but benefit from a special tax regime, display many similar characteristics to the self-employed. Holding accounting books stems from being registered, so half of the micro firms keep accounting records of their business, while only 4 percent of the self-employed do so. However, like the self-employed, 70 percent of the respondents do not have bank account and 90 percent of them conduct their business without written contracts.

Informality, from that point of view, is not only determined by tax compliance, but also by a certain way of organizing business activities. The low score of the self-employed group for these variables should not come as a surprise. However, one can notice that registration did not make the business operation of micro enterprises more formal. From that point of view, self-employed and micro enterprises should be grouped together.

Table 2: degree of formalization of self-employed, micro and small enterprises

		Round 1	Round 2	Round 3	Round 4
Self-employed	low formalization	97	97	97	97

	high formalization	3	3	3	3
Micro firms	low formalization	79	79	85	82
	high formalization	21	21	15	18
Small firms	low formalization	10	6	8	5
	high formalization	90	94	92	95

One can also notice that the degree of formalization is stable for the self-employed over two years and that formalization recedes, albeit, not significantly, in the case of micro firms. On the other hand, the degree of formalization of the cohort of small firms interviewed was high and continued to grow from 2013 to 2015.

If micro firms differ in their activities and education - micro entrepreneurs are better educated, have even university degree, are more active in trade and services while self-employed are mostly active in agriculture - they display the same motivation and attitude to risk. Fear of failure would prevent more than 50 percent of both groups to start new activities or propose new services or products. Half of the self-employed and micro enterprises would be ready to follow training courses if it could improve their businesses, but 70 percent of them would not be ready to take more financial risks to develop further their activities. Asked about the main reason for their activities, 85 percent of the self-employed and micro enterprises declared doing what they do because there was no other choice. Seizing opportunities is a motivation for only 5-10 percent of both groups.

These were the variable chosen to form a scale of the motivation of self-employed, micro and small firms. A high degree of motivation was attributed to the entrepreneurs with 4 or more criteria over 8. Half of the self-employed and micro firms have a high degree of motivation, while about 88 percent of small firms have a high degree of motivation. The degree of motivation shows that entrepreneurship by default is still prevalent among self-employed and micro firms. But they are confident and motivated to improve the state of their business provided it does not lead them to take more financial risks. One does not notice any fundamental change in terms of motivation during the two-years period of the study.

As table 3 below shows, the overwhelming majority of them are not planning to develop their business, nor are they ready to take more financial risk to do so. Only a weak majority would be ready to follow training courses. But perhaps most importantly, self-employed and micro enterprises are both surviving. Revenue are perceived as highly unstable, more than half of both groups earn enough just to survive and their market do not reach further than the municipality.

Table 3: planning and risk variable, self-employed and micro enterprises

Planning and risk variables	Self-employed in Georgia	Micro business in Georgia
Do you plan to expand your business?	%	%
No	90	94
During the coming 3 months	2	2
During the coming 6 months	3	2
Within two years	5	2
Do you plan to sell new product or services, or products or services of better quality?		
No	95	96
New product or services	4	2.5
Products or services of better quality	1	1.5
Would you be ready to follow training courses if it could improve your business?		
Yes	35	45
No	55	55
Would you be ready to take more financial risks to develop your business?		
Yes	19	19
No	69	81

Table 4: “success variables”, self-employed and micro enterprises

“success” variables	Self-employed in Georgia	Micro business in Georgia
Do you think that you earn enough revenue from your business?	%	%
To live comfortably	0	0
To live very simply	12	15
To live normally	31	31
To survive	57	55
Do you think that your revenue is?		
Very stable	1	1
More or less stable	27	36
Not stable at all	72	63
Where do you sell most of your products and services?		
Village	39	4
Municipality	44	93
Other regions in Georgia/Armenia	6	2
Outside of Georgia/Armenia	0	0

Thus formality and entrepreneurship seems to start with small enterprises, which shows very distinct characteristics compared to self-employed and micro firms with regards to formality, but also other dimensions of entrepreneurship (motivation, risk and success variables). They all hold accounting records and have bank accounts, but tend also to plan the development of their activities, show more willingness to take risks and are better informed, have access to bigger markets.

One can first conclude micro firms are much more similar to self-employed than small enterprises. This grey zone in which micro enterprises are suggest that registration and accounting does not constitutes a trigger to full formalization.

Independence tests ³ reveal that degree of formality of self-employed and micro firms and their degree of motivation, the extent to which they plan future activities and the resources they rely on are all significantly associated. For self-employed and micro firms, formalization is strongly linked to the other dimension of entrepreneurship in all the four rounds, whereas it is not the case at all for small firms. This further consolidates the argument that micro firms should be grouped with informal self-employed.

These results should be contextualized against the background of political and economic evolution of Georgia since the turn of century. The development of the SME sector started steadily and efficiently, but was hindered in the early 2000' by high corruption level, unfavorable tax regime, and budget deficit. In other words, economic policy was taking into account the specificities of SMEs, but the institutional environment was not business friendly. The exact opposite phenomenon took place after 2006. Georgia embarked then on radical reforms to change the economic environment and as a result worked on several measures that made entrepreneurial activities easier to undertake. By the same token, corruption level went down as well. The chosen course of economic policy influenced by neoliberalism got rid of government interference in the economic sphere.

The contribution of SMEs to employment, turnover and share of overall production has dropped during the last 12 years. The Russian embargo, the 2008 war and the global financial crisis impacted on these performances. The “policies vacuum” created by the retreat of the government gave rise to numerous measures and development project sponsored by national and international agencies and NGOs. Liberalization and the streamlining of bureaucratic procedures lightened the administrative burden of companies. Georgia successfully implemented and enforced anti-corruption laws. The Grapht Index, reflecting the number of times firms were asked or expected to pay bribes to officials, is twice as low as in Eastern and Central Asia (IFC, 2013). Georgia appears to provide better infrastructure (in terms of infrastructure service delays, water and electricity provision) than its counterparts (IFC, 2013). Public-Private Consultations (PPC) emerged and the quality of the dialogue improved. Business incubators projects and support units, financed by donor organizations do exist. Access to capital has improved, even the progress is mostly visible for big companies.

³ Kendall B and Spearman Rho

But in the informal sector should have retreated in the light of efficient economic institutions. Yet, the degree of the formalization of self-employed and micro firms did not change. Such an interpretation of these empirical evidences suggest that informal economy is not related to economic development only, but to institutions and state building also. That would also explain why, in many transition countries, the informal economy has grown in spite of many reforms (Krstic and Sanfey, 2011).

Conclusion

This article contributes to this debate using a recent dataset from a two year longitudinal cohort study on 350 self-employed, 150 micro entrepreneurs and 100 small firm in Georgia⁴ to examine the linkages between the informal sector and entrepreneurship. The survey offers a look at Georgia's informal economy's heterogeneity. Strictly speaking self-employed are in agriculture. But we have to consider micro firm as well.

It shows that Georgia's informal self-employed display the same characteristic with regard to informality than registered micro-firms. The registration and the holding of accounting record do not provide satisfactory indicator of the boundaries of the informal economy. In Georgia the informal economy encompasses the activities of registered micro enterprises. Indeed, self-employed and micro entrepreneurs share many similarities in the way they are organized and in their motivation and the risk they are prepared to take.

The dynamic picture provided by the four rounds of interviews shows, however, that even if the business environment has improved, the degree of formality has not changed of self-employed and micro enterprises has not changed. In fact, it has actually slightly decreased among micro enterprises. In other words, self-employed and micro entrepreneurs did not formalize, but did not evolve either with regards to the other dimension of entrepreneurship (motivation, planning, risk-taking and performances).

Based on the result of this two-years period study, one cannot conclude that: the informal is a building block for formal private sector development. Since the 1970, the development literature has begun to acknowledge that many workers are self-employed who operate in the informal sector. The entrepreneurship literature has started to view them as entrepreneurs since the turn of the millennium. The old view on the informal sector was that it was going to wane in the face of economic development and that it rests on unregistered, sometime illegal, activities. The new view on the informal economy recognizes that it contributes significantly to GDP and employment and

⁴ “*The emergence and evolution of entrepreneurship in Georgia*”, research project financed by the Gebert Rűf Stiftung and part of Academic Swiss Caucasus Net, University of Fribourg, Switzerland.

that is it made up of diverse activities (Chen, 2007). This article adds up to this new perspective using the dataset produced by a two years' longitudinal study on cohort of self-employed, micro and small enterprises to shows the extent to which they are structured. Entrepreneurship thus being defined as the process of "*discovery and exploitation of profitable opportunities*" (Shane and Venkataraman, 2000:17) starts with small enterprises. The degree of formalization of self-employed and micro entrepreneurs did not evolve in the two years during which the study took place. In other words, self-employed and micro entrepreneurs did not grow and did not formalize their activity. From this point of view, the informal sector does not seem to be a building block for formal private sector development. One must therefore conclude that the informal sector in Georgia is still unproductive and stagnant. Informal entities did not transition to formality, viewed broadly as the way enterprises structure their activities. This confirms La Porta and Shleifer (La Porta and Shleifer, 2014) view of the informal sector as separated from the rest of the economy and add strengths to the dual view of the informal economy.

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