

Formalizing SMEs in Sub-Saharan Africa

Challenges and Recommendations for Entrepreneurs and Investors



About



Investisseurs & Partenaires is an impact investment group dedicated to African Small and Medium Enterprises. Since its creation in 2002, I&P has invested in about 100 companies, located in 16 African countries and operating in various sectors of activity (health, transport, microfinance...). These enterprises create local added value and long-term employment, and generate important social, environmental and governance impact.

I&P provides capital, technical and strategic support to meet the growth needs of its portfolio companies. The team develops long term partnerships with entrepreneurs, sharing management expertise and knowledge that is useful for improving business strategy, structuring, and success.

Created by Patrice Hoppenot in 2002 and headed by Jean-Michel Severino since 2011, the I&P team comprises about fifty collaborators in Paris and in its seven African offices in Burkina Faso, Cameroon, Côte d'Ivoire, Ghana, Madagascar, Niger and Senegal.

To read more: www.ietp.com

Introduction



Jean-Michel SEVERINO, Investisseurs & Partenaires (I&P) CEO

Jean-Michel Severino is CEO of Investisseurs & Partenaires since 2011. Previously, He notably served as Vice-President for Asia at the World Bank (1997-2001) and as Director General of the French Development Agency (2001-2010).

The subject of the informal sector in developing countries has been one of the most vigorously debated in economic and political circles for decades. Opinions by those who view informality as necessary and sustainable, those who consider it beneficial, others who see it as a necessary evil that provides otherwise unattainable income, and still others who believe that its decrease is critical and even imperative. Over the last decades, thousands of pages of academic studies, seminars, and political discussions have attempted to address this complex issue.

Since its creation in 2002, I&P has opted not to weigh in on this debate but rather to dedicate its resources to promoting and supporting the growth of a formal entrepreneurial sector. For the entrepreneur, formalization is vital once the company's growth takes hold and we have always felt that there are substantial direct and indirect benefits for employees as well. For public authorities, in particular in African states with limited resources, any tax benefits (derived from a well-designed and well administered policy!) are invaluable for financing the immense public needs of society. All the SMEs that I&P has supported over the past 17 years have embarked on the path of formalization. Nevertheless, **over the years, we have seen how complex and difficult this process can sometimes be.** There have been times that we have discovered that it is impossible to lead the way to completion. At times we have been surprised by the reluctance and refusals we have encountered. **At a certain point we decided it was time to reflect on our experience with formalization and to share what we have learned along the way.**

We have therefore launched a study on this subject that combines quantitative analyses and qualitative comments of our entrepreneurial companies and partners, their employees, and our investment teams. This research has allowed us to capitalize on our knowledge and to provide an overall picture of what the path to formalization looks like.

We do hope, of course, that this study will inspire African governments, development agencies and scholars. But the most valuable part of this work relates to what is very rarely analyzed and even less frequently shared: the **practical challenges companies face as they progress towards formalization**. Our business gives us access to unique knowledge and insights which are essential to understanding how companies and their employees view public policies, as well as best practices for leading a business towards successful formalization. This study will therefore be of interest to entrepreneurs engaging in the formalization process, as well as to private and public investors who face the challenges of exiting the informal sector.

Between August and October 2018, Investisseurs & Partenaires (I&P) and the Foundation for Studies and Research on International Development (FERDI) jointly **conducted two in-depth studies on the impacts of formal employment in Senegal and Madagascar**. About 500 employees of 10 different companies were interviewed, representing a wide range of sectors, job levels and capacities and contract types. (www.ietp.com)



Impact Assessment of Formal Employment in Senegal

August 2018



Impact Assessment of Formal Employment in Madagascar

October 2018

Contributors



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Samuel joined I&P in 2016. As a PhD student of the CERDI (a research center dedicated to the study of international development), Samuel has notably been working on employment issues for African small and medium enterprises. He conducted the two studies, "Impact Assessment of Formal Employment" in Senegal and in Madagascar.

Interviews & Testimonies



Sébastien BOYÉ, Chief Investment Officer at I&P

Sebastien joined I&P in 2002 and has been involved in I&P's development since the group's inception. He oversees I&P activities with the support of local teams in Côte d'Ivoire, Ghana, and the Sahel region (Burkina Faso, Niger Mali).



Bruno CAIRE, I&P Advisor

Bruno started working for I&P in 2007. Since then, he has carried out numerous missions with investment managers, visiting companies before and after the I&P investment. He supports the team in the process of structuring companies.



Emmanuel COTSOYANNIS, Managing Director, Miarakap

Emmanuel Cotsyannis is the co-founder and CEO of MIARAKAP, Madagascar's first impact fund, sponsored by IPDEV2.



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Olivier FURDELLE, Managing Director, Teranga Capital

Olivier has 20 years of professional experience in impact investing and financing SMEs and entrepreneurs in Africa. He is the Managing Director of Teranga Capital, an equity impact investment vehicle dedicated to financing and supporting high-potential small businesses in Senegal.



Thomas LAURUOL, Consultant

Thomas Lauruol is currently working as an independent consultant. He previously held the position of Investment Director at I&P, where he worked from 2009 to 2018, with a focus on Burkina Faso, Benin, Mali, Niger and Senegal.

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1

A Better Understanding of Informality

What do we mean by “informality?”

The lack of a common definition

The first point to note when we examine the concept of informal economy is that **there is not an unanimously shared definition on the subject**. According to the Organization for Economic Co-operation and Development (OECD), the informal sector includes, for example, “*all activities that are not or only partially recorded*”.

The International Labor Organization (ILO) defines the informal economy as, “*A set of units producing goods or services mainly to create jobs and income for the people concerned. These units, with a low level of organization, operate on a small scale and in a specific way, with little or no division between labor and capital as factors of production. Employment relationships - where they exist - are based primarily on casual employment, kinship or personal and social relationships, rather than contractual agreements with formal guarantees.*”

Key Concepts

Despite the lack of a clear definition shared by all stakeholders, several common characteristics of the informal sector can be identified:

► **Informality does not equate to illegality**

In most cases, the activities of informal enterprises are not criminal or even illegal. They often produce ordinary, legally authorized goods and services. It is rather the way in which they engage in these activities - for example, by evading taxes - that positions them in the informal sector.

*In most cases,
the activities of
informal
enterprises are
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even illegal*

Companies are rarely 100% formal or informal

► **Informal does not imply a lack of remuneration**

Employment is considered informal when a worker does not have a declared employment contract with the relevant public authorities. That being said, this undeclared work is most often remunerated.

► **The lines between formality and informality are blurry**

In many parts of the world, companies are rarely 100% formal or informal. A concrete example: a company can declare part of its income (formality), but not all of it (informality). It can also provide an employment contract to certain employees (formality), while using undeclared subcontractors to increase flexibility (informality). This mixture of formality and informality can take many forms.

► **The most predominantly informal companies are not always the smallest**

While larger and more mature companies are generally more (often) formal than small companies, firms that do tens of millions of euros in annual turnover can also be predominantly informal. This is particularly the case in the Sahel countries.



In the Field

“Informal work in a company refers to any aspect that is not recorded or written down. And when things are not written down in black and white, they can be misinterpreted, they cannot be controlled. This causes a lot of imprecision and inefficiency. With African SMEs, it is a very common situation. For example, companies generally have no written organizational chart, no procedure manual, and so on.” - Bruno Caire, Advisor

“The field of informality is not only about the regulatory dimension; it is much broader than this. Informal enterprises generally do not have a well-established organization or structure. The formalization process we are proposing to them must take all these elements into account.” - Olivier Furdelle, Managing Director of Teranga Capital

“Some of the companies we support have both formal and informal clients. On the one hand, they can sell to formal modern distribution structures, and at the same time sell to people who resell their products in the markets without being declared.” - Raphaël Dumont, Responsable Investissement I&P

“In Sub-Saharan Africa, among companies looking for between 200,000 and 500,000 euros of capital investment, few are 100% formal. They are often formal in terms of their social obligations, but informal in terms of taxation. Double accounting is a widespread practice.” - Thomas Lauruol, Consultant

Origins of the informal sector: An overview of existing theories

How and why does an informal sector develop in a given region or country? Three schools of thought provide different insights into this phenomenon.

The dualist school

The "dualist" school, led by Lewis (1954) and Hart (1973), argues that the informal sector includes **peripheral activities that are not linked to the formal sector**. This is a residual sector that exists because the formal economy is not able to offer employment opportunities to part of the workforce. According to this view, with economic growth and transformation, the informal economy will eventually be absorbed by the formal sector.

The legalistic school

The "legalistic" school, popularized by De Soto (1989), considers that the informal sector is made up of **micro-entrepreneurs trying to avoid the costs and responsibilities of formal registration**. Monetary and time costs stifle private enterprise and drive it into the informal sector. As long as the costs of formalization outweigh the benefits, economic agents will continue to choose informality and regulatory reforms, including property rights and tax cuts are the only means of combating informality. This school of thought argues for the potentially voluntary nature of informality that would arise from a cost-benefit analysis.

The structuralist school

The "structuralist" school, widely defended by Portes (1989), **argues that the informal sector is a characteristic of capitalism**. Unlike other schools of thought, the informal sector appears to be subordinated and even exploited by the formal sector in order to reduce costs and increase the competitiveness of large companies. Global production networks require a high level of flexibility that only the informal economy can provide.

Where are we now?

Due to its very nature, reliable data on the informal sector is difficult to collect. However, some estimates by recognized international organizations reveal how widespread the phenomenon is, particularly in Africa.

Worldwide

According to the latest ILO report (2018)¹, more than 60% of the world's population works in the informal sector. These 2 billion men and women are very often deprived of decent working conditions.

¹ OIT (2018) "Women and Men in the Informal Economy: A Statistical Picture"

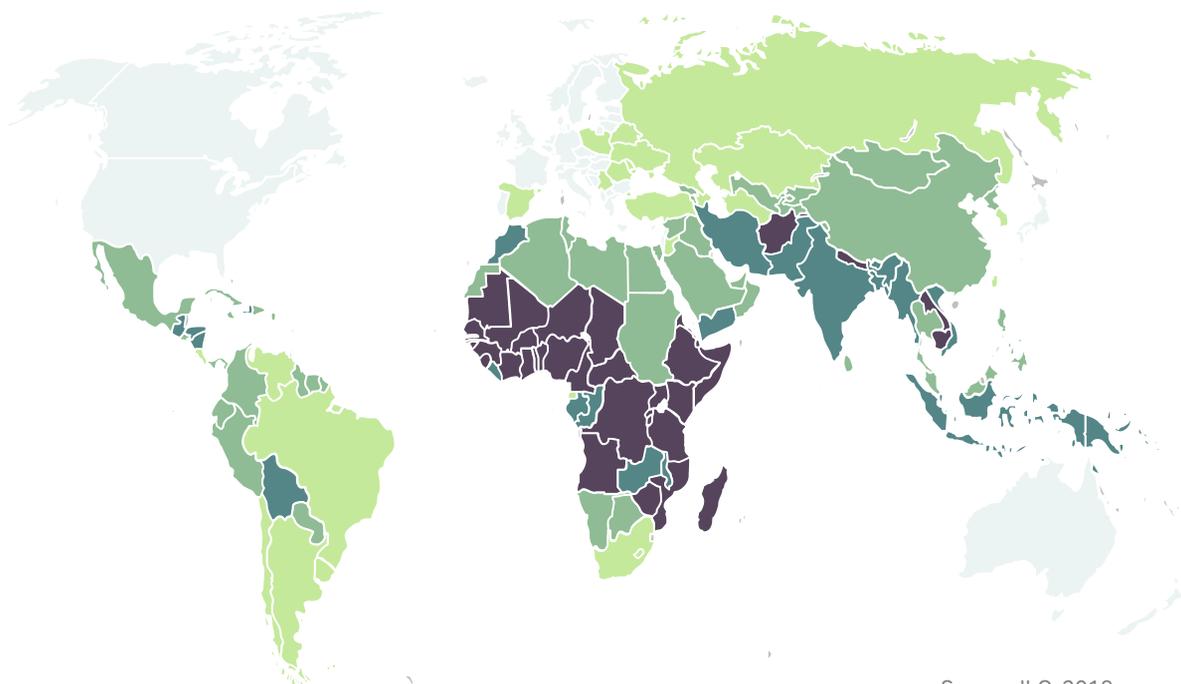
In Sub-Saharan Africa, more than 89% of jobs are informal

In Africa

Informality is particularly high in Sub-Saharan Africa, **where more than 89% of jobs are informal**. This percentage varies greatly from country to country, from 34% in South Africa and 46% in Cape Verde to an overwhelming 95% in Burkina Faso and Benin.

Share of Informal Employment in Total Employment

Less than 20% 20%-49% 50%-74% 75%-89% 90% and over



Source: ILO, 2018

Formalization: a relatively recent process in developed countries

It should not be forgotten that informality was still very common in developed countries such as France in the 1960s and 1970s. "At the time, there were many "grey areas" in companies, even the largest ones," explains I&P advisor Bruno Caire. "*There were no precise or standard quality metrics, for example. The accounting of small businesses was most often done manually.*"

Did the rapid development and implementation of IT throughout French companies force the retreat of this long-standing informality? "*IT certainly plays a role as an accelerator in the formalization process, but it is far from responsible for this shift. Indeed, to computerize a company, there must already be precise, reliable and functional formal processes in place*" says Bruno Caire.

Nevertheless, **the development of digital tools in Africa is undeniably opening up new perspectives in favor of greater formality.** The increasing percentage of mobile payment systems (with improved traceability), the digitization of certain business registration formalities, the increasing possibility to pay taxes online, etc.--these developments are contributing to this dynamic today.

The development of digital tools in Africa is opening up new perspectives in favor of greater formality



● What Objectives for Tomorrow?

The United Nations has adopted 17 Sustainable Development Goals (SDGs) whose mission is to address the global challenges facing humanity, including those related to poverty, inequality, climate, environmental degradation, prosperity, peace and justice¹.

The **issue of informality is directly addressed in SDG n°8**, on decent work and inclusive economic growth. In Section 8.3, the goal is to *“Promote development-oriented policies that support productive activities, decent job creation, entrepreneurship, creativity and innovation, and encourage the formalization and growth of micro-, small- and medium-sized enterprises, including through access to financial services.”*

In addition, **many of the SDGs indirectly address the issue of informality**, particularly SDG n°1 (End poverty in all its forms), SDG n°5 (Gender equality and women’s empowerment), SDG n°10 (Reduce inequality within and among countries) and SDG n°17 (Revitalize global partnership for sustainable development). The SDGs' declared willingness to not "leave anyone behind" naturally speaks to the situation of the billions of workers who are excluded from formal employment around the world.

¹ Source :
<https://www.un.org/sustainable-development/fr/objectifs-de-developpement-durable/>



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Informality on the Company Side

Let's first look at African companies and their relationship to formalization. For a man or woman managing an SME in Sub-Saharan Africa, is formalization necessarily a priority? What are its advantages? Will the company become more or less profitable as a result? What are the impacts on its future development? These are all legitimate questions that do not have simple answers.

Complex and interrelated issues

Why would an entrepreneur choose to operate in the informal sector?

By choosing to place all or part of their venture in the informal sector, an entrepreneur may believe they are taking a rational decision. They generally put forward five general arguments to explain this decision.

Avoiding Public Authorities

- The informal sector is often perceived as a refuge from administrative constraints: taxes, regulations, administrative documents, etc.
- Informal entrepreneurs seek to avoid excessive bureaucracy and fiscal harassment by public authorities

Greater Flexibility

- In the absence of regulations, informality allows for greater flexibility in hiring and work organization.
- Informality makes it easier and quicker to adapt to economic fluctuations.

By choosing informality, an entrepreneur may believe they are taking a rational decision

Family Management

- Often, the children of informal entrepreneurs inherit the social capital and the networks of their parents, which in turn encourages them to operate in the informal sector.
- The family management of a company inherently favors informal development.

Minimizing Risk

- Formalization can be a risky investment: the costs are guaranteed but the benefits are uncertain.
- In the presence of credit constraints, entrepreneurs must be self-financing. They are afraid of losing all their savings.

Procedures that provide little incentive

- Lack of information on administrative structures that allow for simple and inexpensive formalization does not encourage entrepreneurs to formalize.
- Uncertainty about the outcome of the process and what can be requested by the administration encourages people to remain in the informal sector.



Informality Rooted in Practice

In many countries where I&P operates, the use of cash to pay for all goods and services is the norm. In most cases, bribes aren't perceived as such, but are rather seen as simple payments for services and seems to suit most people.

There is also a very low level of consent to taxation, which explains part of rationale for avoiding taxes through informality. Many business leaders do not view taxes as a useful resource for financing roads or schools, but rather as a means of sustaining the personal lifestyles of many civil servants and politicians. In this context, not paying taxes is not perceived as a moral or civic failure; thus, awareness of formalization benefits is more difficult to convey.

Advantages of formalization

The entrepreneur may have the impression of making a beneficial choice by operating in the informal sector, but to what extent is this true? It appears that a company can derive many advantages from formalizing its business activities, particularly in the long term.

Better performances

on average, declared companies increase their profits by 20% and gain more opportunities to advertise¹.

“Behind formalization, there is often a very significant cultural change in a company. By creating an independent legal entity and implementing real governance, we ensure that the entrepreneur doesn’t confuse his own pockets with the company resources. Decisions must be made in the company’s interests. The company must be able to report to its governance bodies and put in place reporting tools and indicators that allow for better decisions and better planning for the future.”

Sébastien Boyé, Chief Investment Officer

¹ Source : “Les Entreprises informelles de l’Afrique de l’Ouest francophone”, Agence Française de Développement, Banque Mondiale, 2012

Easier access to credit

In Dakar, the average interest rate for formal firms is 15.3%, compared to 20.7% for informal ones.

“With tax and accounting formalization, a company naturally gets easier access to financing by investors and banks. However, this also opens doors to working with new customers who require formalized partners. This is generally the case, for example, with large international retailers.”

Olivier Furdelle, Managing Director of Teranga Capital

In Dakar, the average interest rate for formal firms is 15.3%, compared to 20.7% for informal ones

80% of formal companies are connected to the water distribution network, compared to 55% of informal companies

Better connection to public infrastructure networks

In Dakar, 80% of formal companies are connected to the water distribution network, compared to 55% of informal companies¹.

Protection against fraud

Legal contract guarantees provide some protection in the event of legal disputes.

A credibility signal to the market

Formal companies generally provide better quality products through their compliance with safety standards and working conditions.

Easier employee retention and recruitment

By formalizing itself, a company becomes more attractive to potential applicants and its own employees.

“When a company offers formal contracts, it is better able to recruit staff with new skills to support its development.”

Olivier Furdelle, Managing Director of Teranga Capital

“Formalization should not only represent a constraint; it should also be seen as a positive process.”

“Formalization should not only represent a constraint; it should also be seen as a positive process. For example, a formalized company is better able to retain its employees over time. It also helps to boost performance through an enhanced management strategy.”

Emmanuel Cotsoyannis, Managing Director of Mirakap

Disadvantages of formalization

Formalization is a complex process that can be difficult to implement and, in some cases, even a double-edged sword. The disadvantages are just as real as the advantages, especially in certain sectors:

Binding Procedures

The formalization process has disincentivizing monetary, temporal and operational costs, especially due to administrative procedures.

Lack of Flexibility

The informal sector allows companies to react more nimbly to economic fluctuations and easily adapt the number of workers. This level of flexibility is sacrificed with formalization

Skewed competition

It is difficult to compete against informal competitors who do not bear the same costs.

Prohibitive taxes

Being subject to taxes increases de facto costs for the firm.

“Initially, formalization often represents a real financial shock for a company. For example, we have invested in a fast food company that has undertaken a major formalization process. The company’s margins fell by around 30%, 20% of which was due to VAT payments. As a result, the company started to lose money. However, these losses were budgeted for and we managed to regain 20 margin points in the first three months by implementing rigorous procedures and controls.”

Emmanuel Cotsoyannis, Managing Director of Mirakap

“We invested 300,000 euros in a logistics e-commerce-related start-up. When the company formalized, it started paying taxes, duties and VAT overnight, taxes from which it had previously been free. In the first year, the additional cost of this formalization amounted to 45,000 euros. Not all companies are able to absorb such a constraint. It is up to us to evaluate carefully beforehand to ensure that it is worth the effort.”

Olivier Furdelle, Managing Director of Teranga Capital.



Both positive and negative tax impacts

By going formal, **a company generally protects itself against the pressure tax authorities** could previously exert on it. It is no longer vulnerable to extortion by tax inspectors who agree to turn a blind eye to their situation for a price.

However, a company **also becomes more visible** and thus more likely to undergo unfriendly, even corrupt, tax audits. As the tax base in Sub-Saharan Africa is generally very low, states tend to focus their audits on companies that declare their income. To avoid such audits, companies often have to pay large sums, which can sometimes jeopardize their very existence. I&P encourages them to break from this vicious circle, even if they initially incur a cost.

It is worth noting that some entrepreneurs take **collective initiatives to protect themselves from tax pressure**. Such is the case of the "Enablis Senegal" network, a group of small formal companies that pays a chartered accountant to validate their financial statements.

Another form of tax risk is that related to **a company's informal past**. Since there is no form of tax amnesty for arrears, tax authorities can make tax adjustments, sometimes involving very large sums. This creates great complexity for the company, which has to implement complicated arrangements in order to isolate its former informal business from its newly formal one. I&P encourages states and institutions to develop mechanisms for tax amnesty for companies that commit to implementing a formalization process.



Focus: I&P's experience

Since its creation, **I&P has been dedicated to investing in 100% formal companies. In practice, however, this excludes many economic sectors**: in some industries, the influence of the informal sector is too great for a formal company to be able to compete. In sectors such as catering and distribution, it is almost impossible for a company to survive if it becomes formalized. This is particularly true for the sales of non- B-to-B or VAT-exempt products: to offset the cost of VAT, a formal company must charge customers 20% more than its informal competitors or reduce its turnover by 20%, which often puts it out of business. However, the more formal the competition, the easier it is for a company to formalize.

"Sometimes the best favor you can do for an entrepreneur is not to finance them so as to not to impose formalization on the company and risk breaking their economic model. I'm thinking in particular of companies in the consumer goods sector. For example, Madagascar produces peanut oil, yet a lot of peanut oil is still imported from Indonesia, India and Bangladesh. Why? Because production costs are very low: by adding the cost of transport, you achieve more or less the same level of margin as for local oil. Except that the import sector is an informality champion and doesn't pay customs duties or VAT... It is sometimes difficult to fight against that!"

Emmanuel Cotsoyannis, Managing Director of Mirakap

"In its early days, I&P invested in a company that imported groceries. We wanted the company to become 100% formal, while their competitors were all informal. This was a strategic mistake because the company was not on an equal footing with its competitors and the business was unable to take off. We learned a lot from this experience about the need to better select the companies we finance."

Thomas Lauruol, Consultant

In practice: testimonies of African entrepreneurs

The testimonies below are transcripts of interviews conducted during the I&P/FERDI studies of August 2018 (“Evaluation of the Impacts of a Formal Job in Senegal”)

“From 2015 onwards, we said to ourselves that we needed money to continue the company’s development. That’s when we had to formalize. We were already used to paying taxes in the past, but not VAT. This cost was not factored into our pricing and we could not increase our prices by 20%. We started paying VAT in 2016 and it remains a big problem for the company today because VAT weighs very heavily on our results. No matter how hard we try to explain the specific issues related to start-ups, it does not solve the problem. And then as soon as we make the effort to formalize ourselves, the authorities come to audit us over everything! When you’re informal, that doesn’t happen and you’re left alone.”

Logistics service company

“My company has always been formal in the sense that it has always respected the law, for example with VAT payment. However, we have worked hard with our capital partner-investor to make progress on a formality that goes beyond following the law. For example, we have developed internal procedure manuals. I have noticed one thing: making a VAT declaration is relatively simple, whereas tracking stocks and flows, tracking inputs and outputs is much more complicated. Especially since the culture of my country does not lend itself to this, it is considered a lack of trust.”

Electrical energy company

“My mother started the school informally because she didn’t know what management skills the business would require. She also knew that when you start to formalize yourself, it’s like a spiral; it would have created a burden that would have put a strain on the school’s finances. And there is a certain culture of informality here – we consider it to be normal. One of the first projects we carried out was to set up an accounting system. Until then, my mother’s account and the company’s account had been mixed together and you couldn’t tell whether the business was profitable or not. Then, we were contacted by the Grand Duchy of Luxembourg to organize a training session and we had to produce a tax clearance for that. This prompted us to formalize. We went to the tax authorities and paid off our previous debts. From that moment on, we started getting audited at the slightest opportunity. It was an endless loop. We had to make requests for moratorium...”

Training company

“My company is 100% formal. The problem is that we will soon be subject to VAT, while we can hardly collect VAT from our suppliers, who are most often informal. I’ve tried to revisit my purchases by looking for formal suppliers, but in practice we buy a lot—especially vegetables—from the market, where everyone works informally. Otherwise, we haven’t encountered many problems with formalizing, expect that it reduced our margins and we are competing with informal catering companies that do not have the same constraints.”

Fast food company

Our recommendations

3 tips to entrepreneurs

Integrate the company's formalization process in your business plan

It is essential to **plan for the formalization process upstream and integrate it into your business plan from the outset**, in order to ensure that your company's sales prices and margins can bear the additional cost of the new taxes.

Do not underestimate the cultural change

Formalization does not only constitute a legal or fiscal process or one tied to social obligations. For instance, once employment contracts are in order, a company must develop a salary scale and a remuneration policy, write job descriptions, conduct individual interviews with employees, consider a possible training policy, etc.

Formalizing, therefore, means working differently. This significant cultural change can lead some employees to feel overwhelmed, isolated or even to leave the company. It is essential to pay attention to and prepare for these changes by putting concrete actions in place to help employees manage the transition.

Formalizing means working differently. This significant cultural change can lead some employees to feel overwhelmed



Follow a solid formalization methodology: I&P's example

Since its creation in 2002, I&P has supported around 100 African SMEs, covering a wide range of businesses, countries and company sizes (the financing offered ranges from €30,000 to €3 million). Through this experience, **I&P has gradually developed a rigorous methodology to support companies in their formalization process**, an essential step in enabling capital investment.

Step 1: Sound financial and administrative management

During the pre-investment process, the company, supported by I&P, **establishes a roadmap and gives itself about 12 months to comply with the various laws and regulations in force**. This involves reviewing or creating an accounting system from scratch, formalizing all employee employment contracts, filing the necessary tax returns, etc. In some cases, it involves obtaining a land title or a lease for the premises.

Companies often start by formalizing current employees' contracts, as this is usually the least complicated part of the process. After an audit, the missing contracts are created. It is also necessary to file social security declarations.

Step 2: Information management

It is necessary to **go beyond simply complying with the rules** and ask yourself what tools the company needs. This requires establishing clear administrative and financial processes and documenting them in a procedure manual. At the same time, all relevant employees must be trained on these procedures. Finally, the company develops reporting and operational and financial management tools (including a budget).

Step 3: Develop governance bodies

This is less about completely setting up formal structures from the beginning, but rather about beginning by creating, for example, a simplified board of directors which meets every 3 months. The goal is for the company to enter into this process and then to **gradually raise its governance standards**.

Step 4: Roll out a tailor-made roadmap

While the three previous steps apply to all companies, this one focuses on the company's specifics. The company must **identify the areas it wants to improve, and then implement appropriate action plans**. This can be, for instance, recruiting to enrich the company's available skillsets, or improving its quality indicators in anticipation of obtaining a potential environmental or social certification.



Going further: two studies on I&P's experience



IPDEV, a pioneering initiative to promote African SMEs

Investisseurs & Partenaires published a short document reviewing the successes, challenges and primary lessons of its first impact fund created in 2002: Investisseur & Partenaire pour le Développement (IPDEV).

Read more: <http://www.ietp.com/fr/content/lecons-ipdev>



Fifteen Years, Fifteen Lessons from Africa

In 2017, Investisseurs & Partenaires published Fifteen Years, Fifteen Lessons from Africa, a new document designed by the team, highlighting the 15 lessons learned from 15 years of investment with start-ups and SMEs in Sub-Saharan Africa.

Read more: <http://www.ietp.com/en/content/fifteen-years-fifteen-lessons-africa>

The investor's perspective

We give here some advice for any economic actor (investor, incubator, etc.) working with African SMEs:

Firstly: how do we select companies that are capable of formalizing themselves?

► Company business activity and seniority

Some businesses are more easily formalized than others.

It is no coincidence that I&P started by investing in pharmaceutical distribution, as this business is, by nature, already highly structured. You have to be precise and organized in your thinking when you buy products from big companies or issue invoices. The company must manage expiry dates, maintain inventory, and provide reports to administration. Similarly, other companies that lend themselves to formalization are those with B-to-B customers or those that operate in structured sectors, such as telecommunications or IT services.

An easier process for newer companies

“Formalization is often easier when you invest in a young company, because it has not yet had time to develop certain habits. I am thinking, for example, of a fast food company in which we invested when it was only seven months old: it did not yet have an ‘informal’ culture”.

Emmanuel Costoyannis, Miarakap

► Diagnosis and modelling

Take the time to establish an in-depth diagnosis

Before investing in a company, I&P carries out a thorough evaluation, analysis and reconstruction of the company's real situation. Often some tax or accounting information is missing or the company sometimes does not have a legal entity status. Most companies very rarely have up-to-date accounts and have often never filed financial statements...

I&P therefore takes time to analyze the company's real level of formalization and that of its competitors before making an investment. On some points, there may be objective elements to analyze: for example, it is possible to quickly determine whether or not a company declares its entire revenue. On other subjects, I&P must first and foremost trust the entrepreneur in their declarations.

Before investing in a company, I&P carries out a thorough evaluation, analysis and reconstruction of the company's real situation

Modelling, a crucial step

A diagnosis then allows I&P to model the potential impacts of formalization - always negative at the start - on the company's results. This is how we decide whether or not it can handle a formalization process.

“Sometimes the answer is no. This is particularly the case in business sectors where the weight of the informal sector is too great and would distort competition. For example, I worked for two years on a company that produced tissues and toilet paper. It was a great big venture, with an entrepreneur who was very willing to formalize. Nevertheless, after two years, we found that formalization would not be viable”

Sébastien Boyé, Chief Investment Officer

► The entrepreneur's motivations and personality

In business management, the character and ethics of the entrepreneur is a key indicator of the company's future economic and financial health. I&P must quickly make up its mind whether a successful partnership appears viable before investing. A company that needs financing must generally be able to have funds available within 12 months, otherwise it's too late. We must therefore clearly identify who our potential partner is within that time.

I&P works most easily with **people who understand the economic interest of formalizing** and who don't see it as a mere condition for obtaining funds. Some entrepreneurs are simply not interested in formalization and in such cases I&P does not invest.

I&P also observes the entrepreneur's personality from the outset:

“Before investing in a company and engaging in the formalization process, I focus first on the entrepreneur. I try to understand what is important to them, the way they work... This is in no way a value judgment! I just try to break down barriers so that the person can reveal themselves. For example, if they are structured and rigorous, this will be a positive factor. If they are not, we will have to find a way to compensate.”

Bruno Caire, Advisor

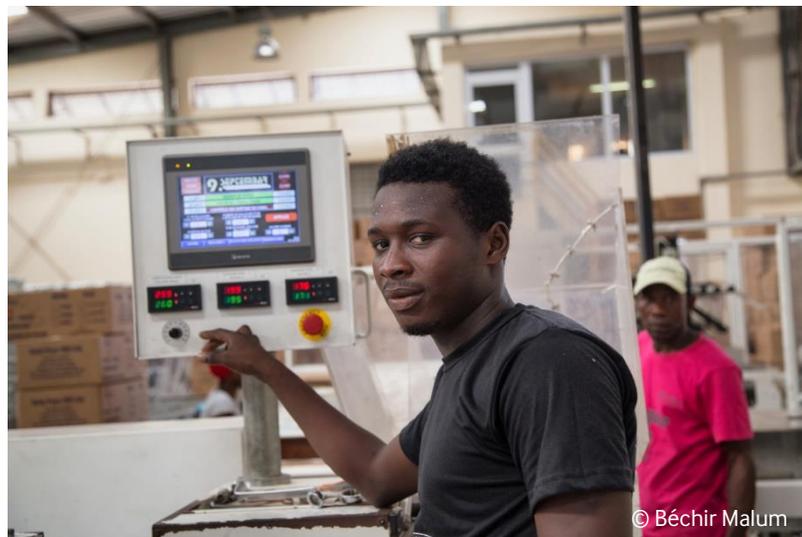
The character and ethics of the entrepreneur is a key indicator of the company's future economic and financial health

Pre-investment: listening, roadmap, methodology

Once the company has been selected, **I&P works with it to define a roadmap, that outlines the different steps leading to formalization.** During the first month, the team must have a clear view of what has happened in the company so far, and then sets up a dashboard to monitor the company's evolution until it has a reliable accounting process in place. The goal is to have a solid balance sheet after one year and to have finished the formalization process by the time I&P disburses the funds granted. When this is not possible, I&P continues the formalization work after the investment, provided that the entrepreneur has previously shown willingness to continue in this direction.

“We bring our experience and most especially the method. Entrepreneurs often get overwhelmed, especially because formalization is not their priority. So, we help them to get organized, we manage the timeline... We do all we can, without of course encroaching on their role as business leaders. We’re there to advise, to listen, to help guide the way forward.”

Thomas Lauruol, Consultant



3

Informality on the Employee Side

In this section we will focus more closely on employees and the impact of formal employment versus informal employment.

Who are informal employees?

The “typical” informal worker is **most often a woman, with little education and whose parents work in the informal sector**. Gender, social background and age directly influence the probability of obtaining an employment contract.



EDUCATION

The less educated an individual is, the higher the probability of their working in the informal sector. Unskilled young people start working in the informal sector at the beginning of their careers in order to prove themselves and test their skills.



SOCIAL BACKGROUND

Having parents who work in the informal sector reduces a person’s chances of having a formal contract in the future. **Family heritage, including family networks**, plays an important role in seizing employment opportunities.



GENDER

Women are over-represented in the informal sector. They often prefer flexible hours that allow them to take care of the household. Under-investment in girls’ education, early marriage, and the lack of access to financing and ownership reduce women’s integration into the formal market. In Africa, nearly 90% of women are employed in the informal sector, compared to 83% of men (ILO).



MARITAL STATUS

Married workers are more likely to access formal employment. This is in part because they are more interested in an employment contract to secure a regular source of income for their family. **Age is also an important factor:** young people have less access to employment contracts.

● Informality: what are the consequences for employees?

Informal employees most often have **insufficient income and precarious living conditions**. This precariousness can affect a worker's productivity and employability, as well as their health, resulting in a **vicious circle of informality and poverty**.

In Senegal, 41% of informal workers are paid less than the legal minimum wage

Poverty

Informal employees face significant poverty that sustains itself. In Senegal, for example, 41% of informal workers are paid less than the legal minimum wage, while they are only 2% of formal employees. Access to electricity is also much lower for informal workers, resulting in radically different living standards.

Vulnerability

Income disparity between workers is higher in the informal sector, especially since **wages are less stable** because due to **overreactions** to fluctuations in the economy: incomes fall more sharply during a crisis. Informality and vulnerability, thus, go hand in hand.

Human Capital

The **stress related to the fear of the future** is detrimental to the health and professional development of informal workers, which in turn affects their productivity. The lack of training makes workers' **skills obsolete and unsuitable** for market requirements, further reducing their employability.



Understanding the obstacles and advantages of formalization for employees: the case of Senegal

A study in Senegal rich in insights

In 2018, I&P and the FERDI (Foundation for Studies and Research on International Development) carried out a study entitled: "Evaluation of the Impact of Formal Employment in Senegal". Its objective was to analyze **what the signing of an employment contract actually changed for employees, both socially and economically.**

204 employees were interviewed in six of I&P's portfolio companies, representing several sectors, levels of corporate hierarchy and contract types.

Methodological Focus

- The study took place between August 20 and September 7, 2018 in Dakar and Richard-Toll, at the offices of various partner companies
- Anonymous questionnaires were submitted to **204 employees.**
- The interviews between the interviewee and the I&P consultant were conducted face-to-face. In order to ensure the honesty of participant responses, no member of the company's management was present during these exchanges.
- This study does not attribute the observed effects directly to the companies. However, it does **illustrate what kind of economic and social impact formalization of these companies has on their employees.**



Download the study on
www.ietp.com



Understanding the Senegalese context



Key facts

Population: 16 million

Urban population: 44%

47% of the population below the poverty line

Official Languages: French

Religions : Muslims (94%), Christians (4%), other (2%)



Development

- **47%** of the 16 million inhabitants live below the poverty line
- The country ranks **164/189** in the **2018 Human Development Report**
- Average salary is around **96,000 CFA** (a little less than 150 euros per month)



Economy

- GDP amounts to nearly **€15 billion**, supported by strong economic growth
- **2nd largest economy** in French-speaking Africa
- 54% of the GDP comes from the **services sector**, boosted by the growth of telecommunications
- **97% of companies are informal**



Entrepreneurial Fabric

- **400,000 economic units** identified in 2017. The average company is 8 years old, a sign of a recent dynamic of company creation
- Entrepreneurs represent **82% of the entrepreneurial fabric**, very small companies 16%, small companies 1%, medium-sized companies 0.4% and large companies 0.2%
- Large companies generate **70% of the total turnover** generated by the country's entire entrepreneurial fabric
- Almost 40% of companies are self-financing and only **5% use bank credit**
- 15% keep written accounts, but **80%** of these use notebooks for this purpose

Having an employment contract: what are the perceived benefits?

For 60% of the employees surveyed, the contract they signed with the I&P portfolio company was their first employment contract. This statistic is even more pronounced among young people: 83% of workers under the age of 25 signed their first employment contract with one of our partner companies.

The “Top 3” benefits

All employees interviewed for the I&P study in Senegal were able to spontaneously cite at least one benefit to the formalization of their job. Here are the top three benefits most often mentioned:

- **Protection against dismissal:** In the absence of unemployment benefits and a state-provided safety net, the guarantee of sustainable employment is a strong argument for formalization.
- **Access to health insurance:** Health care is a major concern - only a few people have access to health coverage and many have to give up treatment due to the inability to pay.
- **A guaranteed salary at the end of each month:** with predictable and stable income, the anxiety associated with the uncertainty of the future decreases and employees can more easily plan for and embark on life projects.

For 60% of the employees surveyed, the contract they signed with the I&P portfolio company was their first employment contract

Let us move on to a more detailed review of the benefits acknowledged by the Senegalese employees interviewed:

Benefit from health insurance

For 73 % of the formal employees surveyed, this current position is the first time they have had health insurance. This insurance contract also allows them to cover an average of two additional people in their household, a rare advantage in Senegal.

Thanks to health insurance, the burden of health expenses has decreased from 23% to 13% of employees' income. That amounts to 10% of their budget that can now be used to satisfy other needs. Note: 95% of insured employees benefit from a third-party payment system and thus do not have to pay any expenses in advance.

For 73 % of the formal employees surveyed, it is the first time they have had health insurance

While 92% of employees prefer contributing to health insurance over not being covered, they are not fully satisfied with their current coverage. 42% of them deplore poor drug management and a lack of partner pharmaceutical institutions.

“Since 2013, companies have been obligated to enroll their employees in a Health Provident Institute (HPI). HPIs are private structures with widely varying costs and rates of coverage. A company can subscribe to the HPI of its choice, but it is difficult to identify them for comparison purposes. Many are quickly closing down because they are struggling to become profitable and can no longer afford to pay for healthcare services. Our company covers 50% of the cost of the employee contribution and our current HPI allows each employee to cover 5 beneficiaries, which was not the case with the previous HPI. Our HPI reimburses 50% of the costs of consultation or hospitalization and 50% of the costs of medicines.”

A Senegalese Company

*Paid leave,
maternity leave,
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These are all
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Access to other social benefits

In addition to health insurance, **formalization gives employees access to other social benefits.** Paid leave, maternity leave, sick leave, retirement, weekly work hour limits... These are all benefits that employees consider particularly useful. **78% of the employees surveyed said this formalization has allowed them to join a pension system for the first time.**

The only drawback is the minimum wage. 27% of employees see no need for it, as it is generally considered too low.

Improvement of Health

Formal employees are generally healthier than their informal counterparts: 48% have been sick in the last 6 months, compared to 70% of informal employees. With often more difficult working conditions, informal employees are more likely to experience health problems. Lacking income and health coverage, they are more frequently forced give up treatment, entering a vicious circle in which their health deteriorates.

A fulfilling job and greater social recognition

83% of employees report that having an employment contract leads to **greater recognition in society**. 73% affirm that the formal contract makes it easier to reconcile their private and professional lives. 80% perceive their contract as a means to **reducing stress associated with the fear of the future**. And 78% of the employees feel more fulfilled in their work if they have an employment contract.

78% of the employees feel more fulfilled in their work if they have an employment contract

Access to banking and credit

The formalization of an employment contract is generally followed by the opening of a bank account, which allows employees to receive their salary via bank transfer. **Access to credit is then facilitated through the building of a banking history**. 82% of formal employees have a bank account and 50% have obtained a loan since their hire (mainly those on permanent contracts). These figures are 42% and 20%, respectively, for informal employees.

Formal employees are twice as likely to have access to credit

“Our company sometimes offers credit-related solutions to employees, particularly during certain religious holidays. These are salary advances that they repay over three months. Some deserving employees can also access these solutions when they want to buy a car, for example. It is quite close to consumer credit.”

A Senegalese company

An advantage for children and housing

Having an employment contract generally provides stability that allows you to project yourself into the future. The decision to have children is therefore made easier: a formal employee has an average of 3 children, compared to 2 for informal employees. 83% of employees also believe that a contract allows them to offer better schooling to their children. In addition, possession of a contract, especially a permanent one, enhances an employee's credibility with banks, making it easier for an employee to become a homeowner.

Disadvantages that persist

While respondents highlight all the perceived advantages of having an employment contract, they also identify several significant disadvantages.

A source of rigidity

37% of employees surveyed cite lack of flexibility as the main disadvantage of formal employment. As they are committed to their formal employer, **they can no longer take advantage of professional opportunities as easily or accumulate additional jobs**, which is a common practice in Senegal. Formal employment often prevents employees from being able to visit their home village – often far from the workplace – or to take time off whenever they wish. These barriers are generally considered significant in a country like Senegal where the flexibility of informality is the norm.

Fear of tax administration

While an employment contract allows an employee to be in good standing on certain points, **it also makes them vulnerable, as other aspects of their household may have remained informal** (casual employment, housing, etc.). As a result, 60% of employees surveyed believe they have more to worry about since they have a formal job. Workers fear increased tax monitoring and sanctions. 45% of formal employees report having been victims of corruption, compared to 34% of informal employees.

Workers fear increased tax monitoring and sanctions



Testimonials from entrepreneurs

“Some employees do not fully understand what a contract is and what its consequences are. There are still communications to be strengthened.”

Senegalese Entrepreneur

“Many employees started out in the informal sector, and it proved complicated to get them into the formal sector. They preferred a salary increase over paying social security contributions. ”

Senegalese Entrepreneur

“If you try to force a worker in a factory to sign an employment contract, he will often quit. In his scale of values, it may be much more important, for instance, to be able to leave to harvest cassava in his village 600km from the capital and then return to work when the harvest ends. He may prefer to keep this freedom, either out of loyalty to his family or in order to remain a part of his original social fabric.”

Thomas Lauruol, Consultant

Our Recommendations

Explain and raise awareness

Formal employment and contracts are not always fully valued because **employees are simply not aware of the benefits**. For example, some people are not aware that health insurance is linked to their employment. Likewise, many do not know that they are contributing part of their salary to retirement. Most employees therefore count only their net salary i.e., the money they have at their disposal, as remuneration. **Explaining the various contributions and benefits provided by an employment contract** is an important element in building company loyalty.

*employees are
simply not aware
of the benefits*

Invest in employees via permanent contracts

Workers overwhelmingly associate the positive impacts of an employment contract with a permanent contract (as opposed to a short-term one). The stability linked to a permanent contract provides employees **increased access to credit and to the pursuit of personal projects**, and also promotes employee development, productivity and loyalty. Therefore, offering this form of contractualization is encouraged and can be viewed as a beneficial investment in the company's success.

Improve health coverage linked to an employment contract

In practice, only 40% of health expenses are covered, while the coverage rates posted often vary around 80%. Many drugs are not covered. This lack of coverage generates dissatisfaction among employees, for whom health insurance is essential.

Compensate for overtime

Even when an employee has an employment contract, **the legal work limits are often not respected** and overtime hours are required. However, this overtime is generally not remunerated. Measures to compensate for these many unpaid and unrecovered overtime hours would strongly enhance the value of the employment contract in the eyes of employees.

Communicate regularly to reassure employees of the company's payment into pensions

Workers often express **doubts about the actual payment of pension contributions**. There are many rumors of companies that have never paid these contributions. It is therefore important to address these concerns, for example by providing employees with their contributor number and providing assistance with account access and/or contacting their pension organization to check their account status if desired.

Conclusion

As we conclude this study on the various issues of the informal economic fabric, we'd like to share a few related thoughts on the relationship, as we perceive it, between companies and public policies and practices.

First and foremost, it appears that the most important obstacle to formalization lies in **the fear, on the part of both entrepreneurs and employees, that formalization will expose them to predation**. While many public actors consider informal entrepreneurs to be fraudsters, informal economic actors fear the criminal behavior that is all too widespread in tax and customs administrations. These actors also renounce formalization often because of the competition from other informal actors, in a context of widespread corruption.

Therefore, combating corruption is the first ally of formalization.

The second obstacle to formalization is the **low cost/benefit ratio of the process** in some cases. The problems of administration of pension and health insurance systems have a significant dampening impact on any potential benefits of formalization. If, in return for their pension contributions, workers were assured of credible and effectively paid pensions, we would see many employee objections disappear....

The second ally of formalization then is simply quality public services and the reality of social benefits in exchange for designated contributions.

The question of the **complexity and cost of the formalization process** is, in our view, only the third most important issue. This is unfortunate because this is, at least theoretically, a relatively easy issue to resolve. That being said, decades of effort, supported by initiatives such as the World Bank's Doing Business, which has fostered competition among governments on this subject, have not been successful to date. There are two sides to this problem. The first is the low level of literacy and skills of both entrepreneurs and employees, which leaves them ill-equipped to deal with mandatory public administration procedures. The other problem is the administrations themselves: their fear of losing power and control and their high-degree of (often needless) complexity are challenging, to say the least.

The third ally of formalization is therefore the simplification and facilitation of procedures, including the development of electronic administration, as well as the general improvement of employees' basic skills, starting with improved literacy.

Barriers to the three “allies” of formalization outlined above are sufficient to suggest that we will continue to live with the informal sector for many years to come. As our study has shown, most companies and their employees will continue to live partly both in the formal and in the informal sectors, finding coherent optimization strategies at their level. This observation is essential to understanding the social landscape of each African country.

However, it is reasonable to believe that **improvement of fundamentals in the African business** landscape (economic growth, improved training, increasing quality of public policies, diffusion of new technologies in a context of better governance) **will produce gradual but significant effects that will deeply improve the situation of African companies**, and thus their competitiveness.



