

# POLICY BRIEF

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## From crisis to survival: How informal enterprises harness the power of innovation

*Researchers conducting an informal innovation survey meet Mr Gwala at his business premises in Mpumaza, Sweetwaters, to learn more about the challenges and opportunities of the local business environment.*  
**Photo: HSRC**



### Introduction

South Africa's informal sector continues to grow in the current COVID-19 crisis, providing livelihoods, as well as goods and services, while formal employment shrinks in South Africa and globally. The continued relevance of the sector – as a form of survival for households and communities – highlights the fault lines in current policy, which values formality to achieve compliance, rather than the myriad interventions that could support informal enterprise resilience and growth.

Some provincial governments have designed policy strategies oriented to create a more enabling environment for the 'informal economy'<sup>1</sup>. Local government is particularly significant as they are responsible for regulations around registration and standards that impact informal enterprise operations directly. However, current policy for informal enterprises is focussed on enabling formalisation, regulation, and taxation.

To inform effective policy responses that will promote a flourishing informal business sector, a stronger understanding of the pathways that successful informal enterprises follow to evolve into sustainable, profitable businesses, is needed.

Based on recent research measuring innovation in the informal sector in Mpumaza, KwaZulu-Natal, this policy brief provides fresh insights into how informal enterprises turn to innovation in response to crisis events. While the COVID-19 pandemic is a crisis that has engulfed the whole of society, it is akin to the personal and economic

challenges that vulnerable informal enterprises experience repeatedly. Their experiences and innovation capabilities thus hold value in the current policy context.

Our analysis shows that firstly, incremental innovations typically found in the informal sector contribute to the business evolution that is needed for resilience and growth. Secondly, informal enterprises that respond to crisis events (such as an illness or impending financial ruin) by innovating, tend to evolve and change the level of formality their business occupies. It is through a change in formality that businesses grow towards becoming sustainable and productive beyond being merely survivalist. However, a change in formality does not necessarily follow a linear path of progress and is often incremental in nature. This allows for policy intervention at numerous leverage points in the lifecycle of an informal enterprise. Overall, the research also suggests that effective policy interventions must promote informal enterprise innovation by nurturing learning networks and creating an enabling environment for innovation. In this way, informal sector policy and innovation policy can contribute to the capabilities needed to create sustainable and viable businesses.

This includes nurturing the absorptive capabilities of informal businesses to recognise the value of new knowledge and information, and use and apply it, even if incrementally. For Kraemer-Mbula and Wunsch-Vincent, developing absorptive capabilities in informal businesses can also include imitation:

<sup>1</sup> Department of Economic Development and Tourism (2010) Policy for the informal economy of KwaZulu-Natal. [http://www.msunduzi.gov.za/site/search/downloadencode/Final\\_Policy\\_\\_\\_Informal\\_Economy\\_2.pdf](http://www.msunduzi.gov.za/site/search/downloadencode/Final_Policy___Informal_Economy_2.pdf)



... that innovation takes the forms of imitation does not make it any less important economically. It may be the necessary condition for the business to maintain a competitive position in the local market. At a more aggregated level, it will be central to the capacity of these firms to generate needed employment and contribute to industrial production.<sup>2</sup>

### Innovation in the informal sector

A local innovation and production system is the network of linkages between informal enterprises, customers, and suppliers in a geographic area. It provides a helpful framework to analyse informal enterprises and highlight opportunities for growth.<sup>3</sup> Research shows that healthy local innovation and production systems have benefits for all participants. Informal innovators (e.g. business owners) may, however, also experience barriers to growth within the local innovation and production system that they are part of.<sup>4</sup>

Barriers to growth that exist in a local innovation and production system may relate to popularising innovation and innovators locally, or regionally, and the creation or strengthening of infrastructural requirements for innovation. Although other businesses were reportedly the second most important partner for innovation in Mpumala, our research revealed that linkages between businesses were weak, with interaction often taking place only once or twice a year.

These included interactions with suppliers, competitors, and businesses included in clusters. Interactions with actors outside the production value chain were even less frequent, with the bulk of businesses reporting no interaction with NGOs (91,3%), research organisations (92,3%), government departments and extension workers (89,0%), or higher education institutions and staff (89,5%).

As a peri-urban area close to the city of Pietermaritzburg and its conurbation with Durban and other economic nodes, policy and other interventions to support

innovation could facilitate interaction and networking for impactful learning and business evolution. This local economic development facilitation could include practical support for innovators in their activities that aim to grow and strengthen networks for local innovation.

### Innovation as a shock absorber in times of crises

In South Africa and other African countries, millions of households and individuals have historically sought their livelihoods in the informal sector, often in response to economic crises, with the growth in the informal sector widely believed to be a counter-cyclical 'shock absorber'.<sup>5</sup>

The informal sector is, however, not insulated from the economic shocks and global volatility resulting from the lockdown strategies adopted to prevent the spread of COVID-19. With limited savings and other buffers, informal entrepreneurs may be even more severely impacted.<sup>6</sup> Preceding COVID-19, our research found that innovation often took place in informal businesses in response to crisis events of a personal or economic nature. The way in which businesses evolve through innovation in response to such events is important for policy interventions aimed at the informal sector.

Innovation in the informal sector is very different from the kind of innovation typically found in the formal sector. Innovations in the informal sector are a 'bricolage',<sup>7</sup> where resources are constrained, providing practical solutions to everyday problems. The 'Bricolage lens in entrepreneurship literature helps to understand resource acquisition in resource-poor environments' and how owners of informal businesses use the resources available to them for innovation<sup>8</sup>.

To create pathways for economic recovery post-COVID-19, public policy must engage with the realities and persistence of the informal sector, and significantly, with the central role innovation plays in enterprise resilience and growth. A shortcoming is that policies targeted at the informal sector are generally based on the

2 Kraemer-Mbula E, & Wunsch-Vincent S (2016) (Eds.) The informal economy in developing nations. Cambridge: Cambridge University Press

3 Cassiolato, JE, Lastres HMM, Matos M & Szapiro M (2018) Local innovation and production systems: RedeSist's conceptual framework and analytical methodology. Paper presented at the Globelics Conference, Accra (October 2018)

4 Hoffecker E (2018) Local Innovation: what it is and why it matters for development economies. NDIR Working Paper 01, Cambridge, US: MIT D-Lab

5 Khambule I (2020) The effects of COVID-19 on the South African informal economy: limits and pitfalls of government's response. Loyola Journal of Social Sciences 34(1): 91–110

6 Koveos P (2020) COVID-19, economic crisis and the informal sector. Journal of Developmental Entrepreneurship 25(2): 1–3

7 Florin J & Schmidt E (2011) Creating shared value in the hybrid venture arena: a business model innovation perspective. Journal of Social Entrepreneurship 2(2): 165–197

8 Hoffecker E (2018)

## Innovation for informal enterprise resilience and growth in times of crises

The research found that crisis events triggered change and innovation responses that contributed to business evolution, through a change in degree of informality. Crises included financial loss, crime and illness: events that disrupted the everyday operations of the business. Our research showed that these innovation events acted as a stimulus for change, and in turn were linked to change in the level of formality. Table 1 presents evidence of such events catalogued in our research.

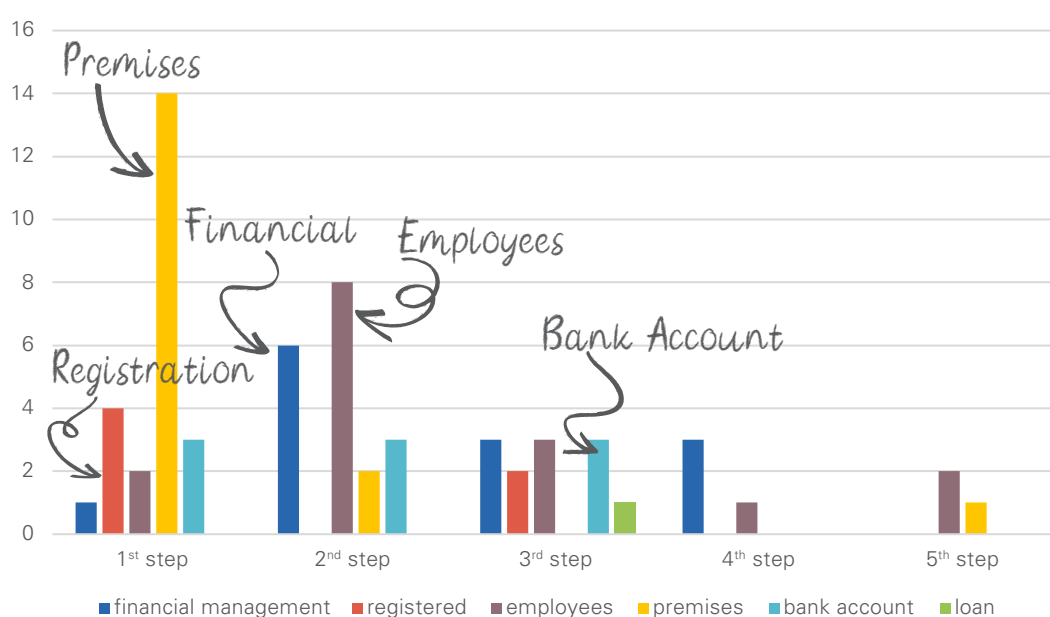
**Table 1: Impact of crisis events on enterprise formality**

Event category	Event detail	Innovation response	Innovation outcome	Effect on informality
Financial	Debt	Added goods or services based on customer demand	More customers	Added employees
	Debt	Different way of doing things	Improved business efficiency	Moved to better premises
	Debt	Different way of doing things	Increased profits due to improved business management, with stock monitoring and transaction tracking	Improved financial management
Personal	Financial loss due to goods not selling	Added goods based on customer demand	More customers	None reported
	Police raided store, standing lost in community	Added goods or services	Added service helped the business survive	None reported
	Car accident	Added goods or services and different way of doing things	More customers and different business offerings	Added employees, more sustainable
	Illness	Different way of doing things	Improved quality of business offering	Financial management
	Burglary	Different way of doing things	Market differentiation	Registered the business
	Was arrested	Different way of doing things	Improved the business through the introduction of safety equipment	None reported
	Illness	Different way of doing things	Improved business and financial management	Moved to better premises.

Source: Table extracted from Petersen et al.<sup>9</sup>

Our analysis shows that business evolution in informal businesses is non-linear, contrary to what is commonly taken for granted in policy.

**Figure 1: Actions that contribute to informal business evolution**

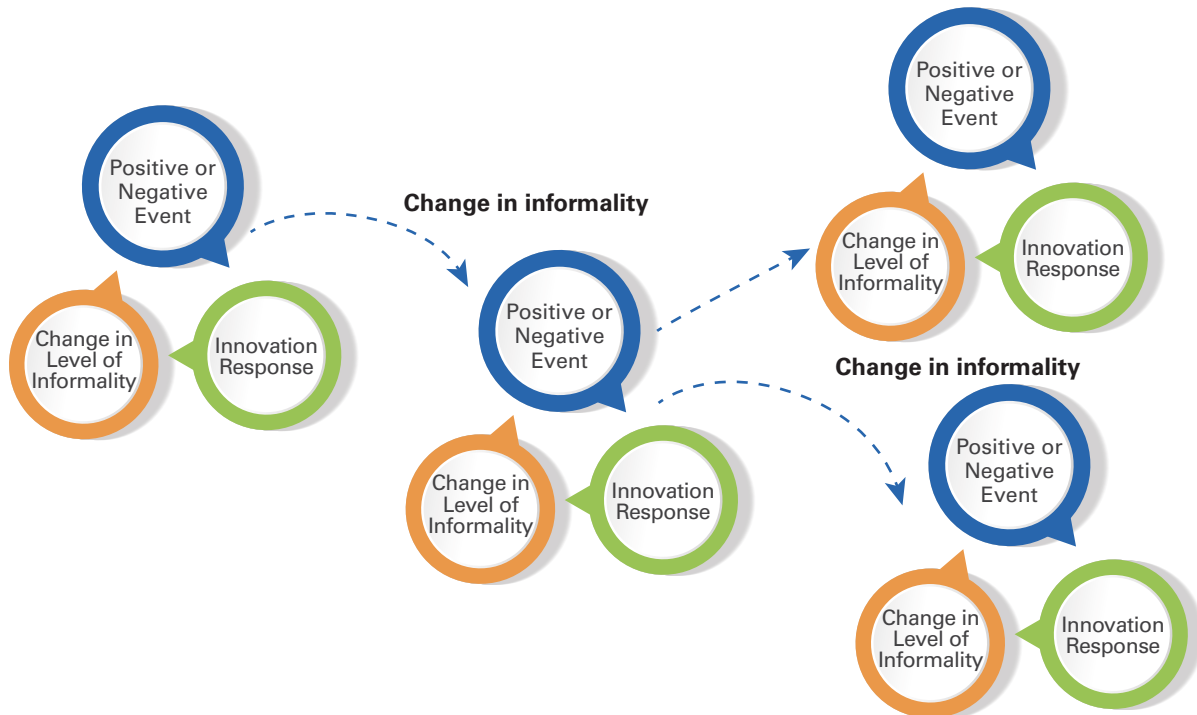


<sup>9</sup> Petersen I, Mustapha N, Van Rheede N & Kruss G (n.d.) *Harnessing innovation in the informal food services sector: insights for public policy in the age of COVID-19*. Working paper, Pretoria: HSRC CeSTII



Current policy<sup>10</sup> emphasis is on formalisation, specifically company registration or tax registration and compliance. As illustrated in Figure 2, our research reveals that the growth trajectory of informal businesses takes place along multiple pathways of evolution, and that multiple degrees of formality exist. Informal enterprises evolve by, among others, acquiring new technical abilities, adapting their organisational structures to better suit current business needs, or by upskilling their employees.

**Figure 2: Innovation events that shift informality levels.**



Source: *Innovation in the informal sector – food case study report (CeSTII, 2020).*

Formality and informality are therefore better conceptualised as mutable stages, rather than binary opposites or progression along a linear, uni-directional path. Understanding formality as multi-layered can provide policy insights into the role of innovation in business evolution in the informal sector, considering that innovation tends to be undertaken in response to a crisis event or innovation event to keep the business operational.

## **Key findings and recommendations: Business pathways driven by innovation events**

### ***Finding: Innovation is essential for the informal sector***

Innovation plays a central role in enterprise resilience and growth in the informal sector. The emerging evidence suggests that informal enterprises innovate out of necessity rather than opportunity, but that this allows them to adapt fast to changing environments and customer needs to stay in business. In general, the analysis of innovation activities in the informal sector shows that a very high proportion of informal enterprises (82.6%) are engaged in some form of innovation activity.

### ***Policy recommendation: Strengthen linkages between government, learning and financial institutions to support informal enterprises' innovation capabilities.***

In order to strengthen innovation capacity, the learning potential needs to be improved through greater policy-driven linkages with actors in the local subsystems. The interactions with government actors and learning institutions are arguably where the most improvement can come to grow the local innovation and production systems (LIPSs), given that these are the areas with the weakest interactions. Also, the interactions with financing actors are very low. This is typically due to the requirement of achieving registered business status to access formal sources of financing innovations, or indeed any other business functions.

<sup>10</sup> *National Small Business Act 102 1996, amended 2004.* [https://www.gov.za/sites/default/files/gcis\\_document/201409/act102of1996.pdf](https://www.gov.za/sites/default/files/gcis_document/201409/act102of1996.pdf)  
*National Empowerment Fund Act 105 of 1998.* [http://www.thedtic.gov.za/wpcontent/uploads/empowerment\\_fund\\_act.pdf](http://www.thedtic.gov.za/wpcontent/uploads/empowerment_fund_act.pdf)  
 Rural and Community Development Fund established by the *National Empowerment Fund Act 105 of 1998.* <https://www.nefcorp.co.za/products-services/funding-criteria/>  
*eThekweni's Informal Economy Policy 2002.* <https://www.wiego.org/sites/default/files/resources/files/eThekweni-Informal-Economy-Policy.pdf>  
 CeSTII (2020) *Innovation in the informal sector: a case study on business evolution and innovation in the informal food sector.* HSRC report. Unpublished.



### ***Finding: Business registration is not a good indicator of growth and formality***

Although current policy equates business registration with attaining formality, the reality in the informal sector is that there are varying degrees of formality that can be achieved by attaining specific attributes. These are depicted in Figure 1 (firm size, registration status, financial management, premises, and employees). Only a small proportion of businesses report business registration as the first step, while others only register after other conditions have been met.

### ***Policy recommendation: Prioritise business evolution, rather than formalisation***

The journey from informal to formal should not be viewed as linear. By understanding the influences of formality, policy could be directed towards providing support for micro-enterprises and focus on building formalisation capability, in that the enterprise could seek assistance as is organically required in its growth and evolutionary trajectory. Resources and policies to support this expansion need to be made available in a drive not towards formality, but the stable expansion of the business.

### ***Finding: Crisis events trigger innovation***

Innovation triggered by an event such as financial loss, crime, or illness, direct attention to the link between the role of innovation and business resilience. Different patterns of business evolution may exist. Fixed premises was highlighted as the most important and was typically the first condition deemed necessary by the owner to support a business for growth and competitiveness.

### ***Policy recommendation: Adopt a development approach to business evolution***

Change in informality may be progressive or regressive, dependent on how the business owner responds to a crisis event. Various policy interventions, such as assisting informal enterprises to mitigate risks related to crises events, could increase the likelihood of informality being progressive. Such interventions could facilitate the access for informal enterprises to business insurance or finance. Although registration may to some degree provide access to these resources, we argue that a development-oriented approach be adopted to support the growth of informal enterprises. Registration does not necessarily equip the owner with accessibility to insurance or finance, but a more evolved business may be the key to unlocking such stabilisation resources.

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