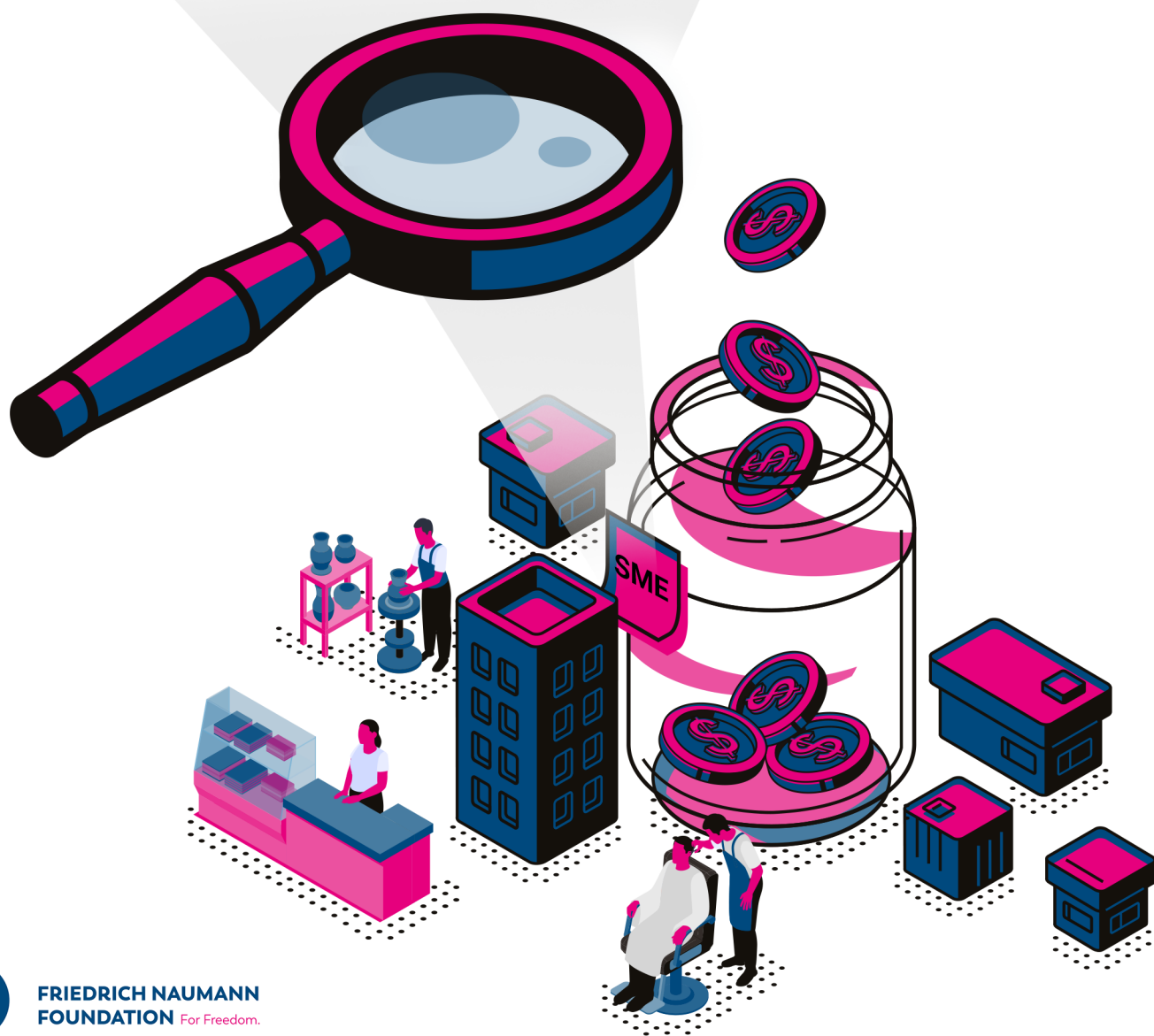


EXPLORING INFORMAL SME SECTOR IN SRI LANKA - 2021

The Nature and Challenges



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The Friedrich Naumann Foundation for Freedom was established in Germany in 1958 by the first president of the Republic of Germany, Theodor Heuss. The Foundation aims to promote the goal of making the principle of freedom valid for the dignity of all people and in all areas of society, both in Germany and abroad.

Our work is funded by the German Parliament through the Federal Ministry of Economic Cooperation and Development, the Foreign Office and, increasingly by the European Union. The Friedrich Naumann Foundation for Freedom works in over 60 countries worldwide.

In South Asia, FNF has offices in India, Pakistan, Bangladesh and Sri Lanka. Additionally FNF works with partners in Nepal, Bhutan and the Maldives. The association of our Foundation for Freedom with Sri Lanka is five decades old. During the period 1968 to 2013, and upon recommencing its work in 2016 the Foundation's work focuses on the core values of freedom and responsibility



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Sri Lanka

Executive Summary

This study fills an important gap in our knowledge with respect to informal small and medium enterprises in Sri Lanka. The value of this study highlights what types of businesses are common in informal SMEs, the nature of informal SMEs, their challenges and issues and provides practical recommendations to overcome the challenges. The study used a mixed approach which had a survey and focus-group discussions to collect data. There are 277 informal SMEs who participated in the survey and 06 focus group discussions were conducted. Quantitative and qualitative analysis was equally important because of the potential contribution of this sector to increase the national output and create employment opportunities which reduce the income disparities within the society. Most of the businesses highlighted that market operation became a major challenge as lack of market selection skills and setting a suitable price. Due to the current situation in Sri Lanka, funding businesses became another challenge for them. Problems arising not only from the marketing and financing but also from the regulatory system in which they function, limit the transition and evolution of SMEs. Technology is becoming a major challenge in the market in order to increase productivity, quality, market and competition. Finally, this study identified that there must be a proper system to overcome the challenges faced by informal SMEs which can lead to being formal while promoting entrepreneurship.

Contributors

Dr Kalpana Ambepitiya – *Principal Researcher*

Ms Dinithi Liyanage – *Research Assistant*

Foreword

The report intends to discuss one of the crucial aspects of the nation's economic contribution. The informal SME sector contributes invisibly to the growth of the gross domestic product, the creation of jobs, and the development of medium-sized and big companies. The purpose of this study is to shatter the taboo and comprehend the characteristics of Sri Lanka's informal SME sector. Thus, the output consists of three main components: recognizing the difficulties and problems, particularly those relating to operations; managing; and offering recommendations for expanding this industry.

As the project's principal researcher, I consider this sector to be of national importance since it has the potential to boost the nation's output, lower unemployment, and expand as a support sector for medium and big businesses. As a result, the informal sector may focus primarily on promoting economic mobility and reducing the income gap between rural and urban regions.

This study generated several important recommendations that may be utilized to create a national policy for the nation's informal SME sector. They consist of information creation and dissemination, a discussion of sustainable business practices, a transparent funding application procedure, strategies for expanding markets, quality control of goods and services, and training and development. It is also necessary to simplify government and financial processes.

Dr (Ph.D.) Kalpana Ambepitiya

Principal Researcher

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01 | Introduction

Addressing the needs of informal firms is an essential priority for policymakers and development practitioners. As per some estimation, 80% of businesses in developing countries are contributed by informal small and medium enterprises (International Finance Corporation, 2013). The informal sector in developing countries occupies 60% of the labor force. However, informality explains the low levels of national development and the level of poverty.

Also, it determines the low quality and lower productivity in the production and labor force (Matsongoni and Mutambara, 2018). Thus, informal SMEs keep the economy at rest by providing informal employment and contributing to the national income. This emphasizes the significance of analyzing this sector in more detail which may support making national strategies and policies to overcome future challenges.

Furthermore, it is certain that the informal sector is more prominent in developing countries than developed countries, and its contribution to GDP is significant (De Silva, 2013). In Sri Lanka, the informal sector works with the formal sector provides a typical example of functioning collaboratively in economic growth. The contribution to the informal sector is stronger

80% of businesses in developing countries are contributed by informal small and medium enterprises

in the rural areas through government support established in administration and markets development in urban areas (Senanayake, Wimalarathna and Premarathna, 2015). Thus, the transformation of supportive services to the informal sector in rural areas requires further attention and this report elaborates on the need.

02 | Overview of Sri Lanka's Informal SME sector

Small & Medium Enterprises (SMEs) play a vital role in the socio-economic development of Sri Lanka. It is estimated that SMEs account for over 90% of the businesses and 45% of the country's labour force (Gunawardena, 2020). SMEs have consistently been highlighted across the spectrum of political parties as avenues for sustainable economic development and innovation. Several promises have been made to enhance SMEs' status and capabilities through targeted assistance mechanisms aimed at strengthening the role of formal and informal SMEs in the Sri Lankan economy. However, the SME sector in Sri Lanka is constrained by funds, poor infrastructure, lack of SME database, lack of monitoring mechanism, and lack of a

It is estimated that SMEs account for over 90% of the businesses and 45% of Sri Lanka's labour force

well-integrated SME authority (one-stop-shop) set up by the government. SMEs in Sri Lanka serve in the formal and informal economies. Indeed, the evidence proves that the informal and formal enterprises differentiated in terms of their capitalization, market penetration, labor utilization, and organization. However,

some argue that informal firms habitually move upward in a hierarchy of organizational forms and finally set up a formal sector unit through vertical linkages (Senanayake, Wimalarathna and Premarathna, 2015). The markets, products, technology, organizational environment, and other vertical integrations are considered as the linkages to move from informal enterprise to formal enterprise.

The informal firm is defined as all unregistered firms with the registration office, municipality, or tax authority, or owners and employers of micro-enterprises that employ few paid workers (ILO, 2012). In terms of production, all incorporated enterprises, general government, Not profit institutions serving households, Other Not profit institutions, and other unincorporated enterprises that maintain a complete set of accounts are considered part of the formal sector. Thus, Sri Lanka has a large informal

economy. The Informal Sector is a subdivision of the Domestic Sector, unincorporated businesses that don't keep a complete set of accounts with at least some detail. Most of their product is sold or traded on the open market. They are the activities that take place in people's homes, small stores, workshops, or anywhere else that isn't a permanent site. the activities of the households as employers of domestic workers and manufacturers of their own end-product are not considered to be part of the informal economy. Many informal businesses are run by a single person, as self-employed or as a team with the

help of unpaid family members. Other informal firms are engaged by paid workers. Most of the informal firms involve activities with a certain amount of investment, level of expertise, and professional services.

03 | The Problem

Many publications and scholarly work have addressed the nature of the SME sector in Sri Lanka in common, without addressing the differences, challenges, characteristics, reasons, and nature of formal and informal sectors separately. Hence, an information gap exists when considering the informal SME sector's contribution to economic development and its nature. Therefore, it has been notified that the requirement to investigate the informal SME sector and its' unique characteristics, situational problems, and challenges have not been addressed in previous research.

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04 | Objectives

- 01.** To identify what businesses, account for the informal SME sector in Sri Lanka.
- 02.** To understand the nature of the Informal SME sector in Sri Lanka.
- 03.** To explain what issues and challenges face by the informal SME sector in Sri Lanka.
- 04.** To provide suggestions for the growth of the informal SME sector in Sri Lanka.

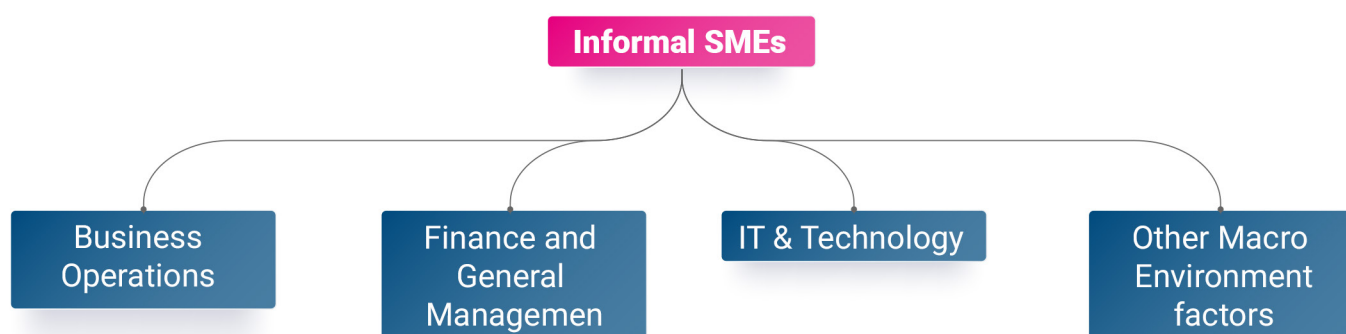
05 | Methodology

Research Design	Quantitative and Quantitative
Population	Informal SME sector
Sample (Data gathered)	277 SMEs for quantitative data 06 focus group for qualitative data
Sampling Technique	Convenient sampling – Provincial based
Questionnaire distribution	Distribution through SED, Widatha officers at AG offices, and social media SME groups
Data collection	Self-Administrative Questionnaire survey – Online Focus Group Discussions
Data analysis	Microsoft Excel – Quantitative data Thematic Analysis – Qualitative data

06 | Limitations

- The survey was taken online due to the COVID 19 restrictions.
- The sampling technique that required changing to Convenience sampling due to the lack of databases and responses.
- Data collection period was extended due to the fewer responses recorded. Most respondents were reluctant to participate in the survey fearing government scrutiny and future tax evasion. The questionnaire reached out to more than 1000 population in informal enterprises. The survey initially targeted to collect 250 responses but ended up collecting 241 due to the same reason mentioned above.
- The responses have been received only from Western, Sabaragamuwa, Southern, Wayamba, Uva, Central, and Eastern provinces though the survey initially targeted to cover all provinces. North and Northeastern provinces were not responded to the distribution.

07 | Underlined Variables of the Survey



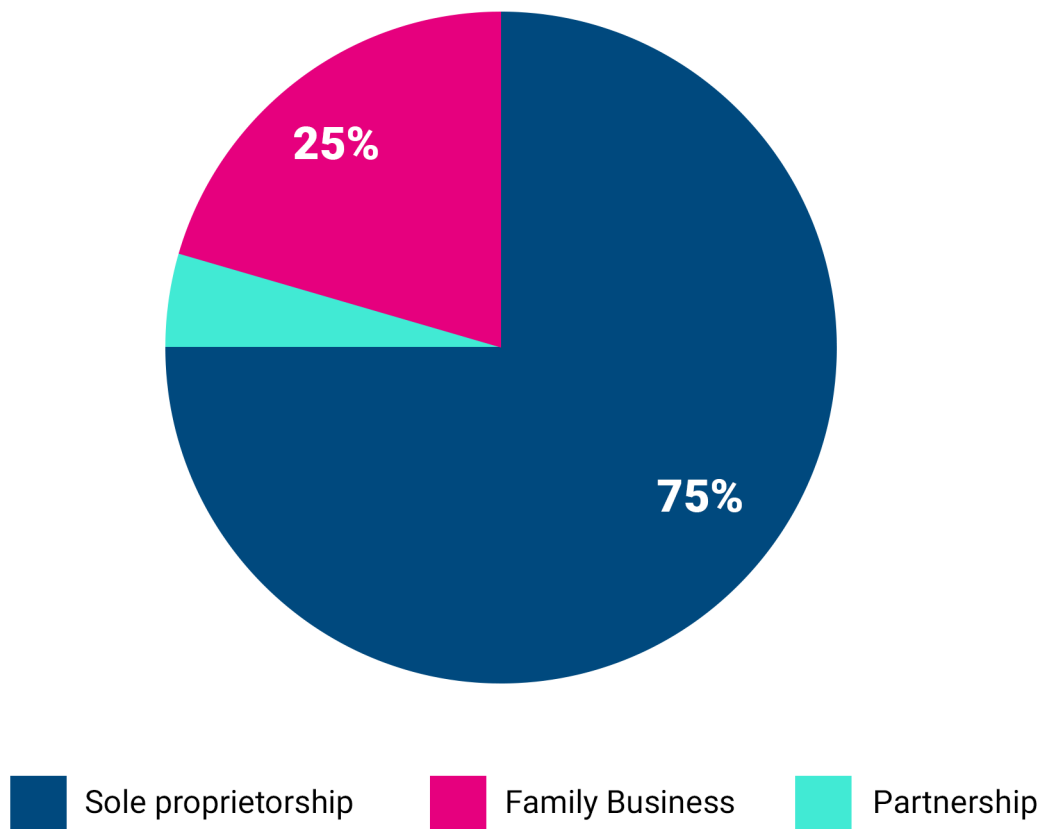
08 | Findings of the Survey

8.1 Quantitative data presentation

The island-wide survey was conducted between the period from 15th October 2021 to 05th January 2022 covering a total sample of 277 respondents (Informal SMEs) in the nine provinces.

Nature of the Business	Percentage
Manufacturing	0.7%
Export	1.8%
Apparel	14.4%
Construction	2.9%
Handicraft	3.2%
Agriculture	11.2%
Bookshop	0.4%
Food and beverages	35.7%
Retail	7.6%
IT	0.7%
Gardening and landscaping	0.7%
Gems	1.1%
Vehicle painting and Tinkering	3.6%
Supplies for events	1.1%
Welding	1.4%
Music Band	0.7%
Delivery	0.7%
Renting rooms	1.1%
Other	10.9%

Type of the Business



The Survey of Informal SMEs in Sri Lanka starts off with finding the business type of the participants. The overall summary is as follows:

- 209 participants are sole proprietors.
- 57 participants are doing their family businesses.
- 11 of them are having partnerships.

In summary, out of 277 participants majority of them have their own businesses, in percentage, it is 75%. While the least number of them have partnerships, in percentage it is 4%.

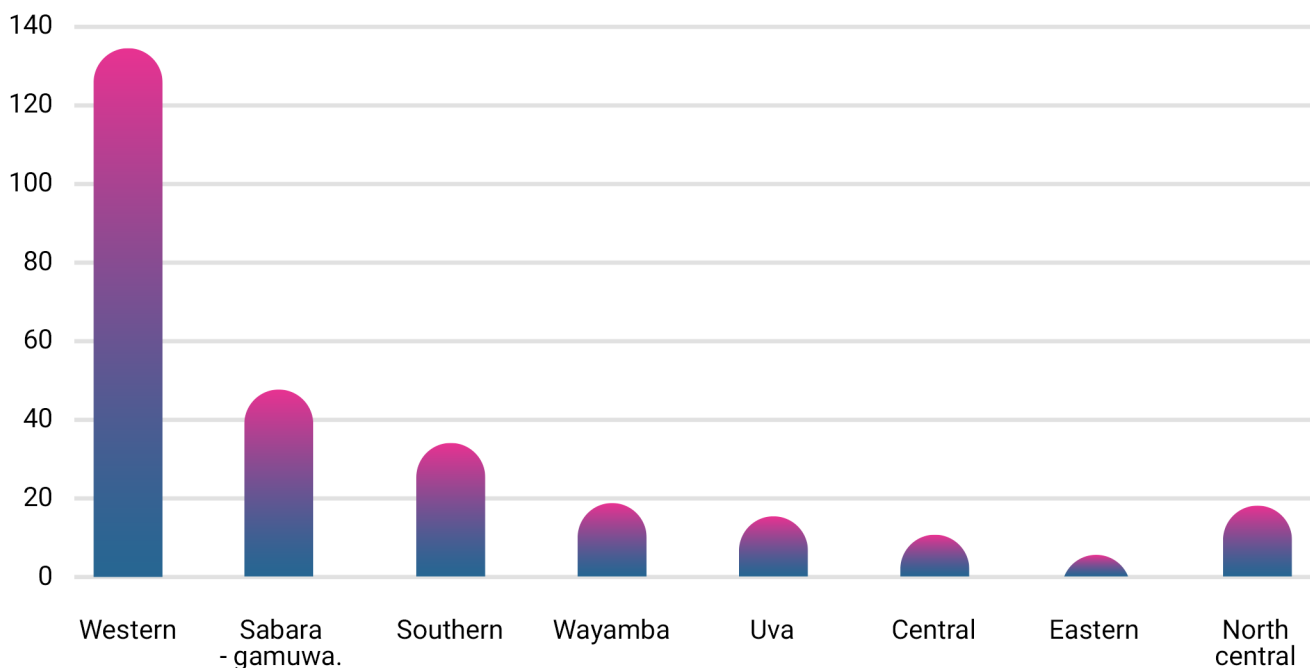
Province

As this survey was conducted to represent each province of the country, as shown in the following bar chart.

- 133 participants are from the Western province.
- 45 of them are from Sabaragamuwa.
- 33 of them are from the Southern province.

- 20 of them are from the North central province.
- Less than 10 have participated from other provinces.

Most of the participants were from the western province. As in percentage, this is 48%. The least number of participants are from the Eastern province

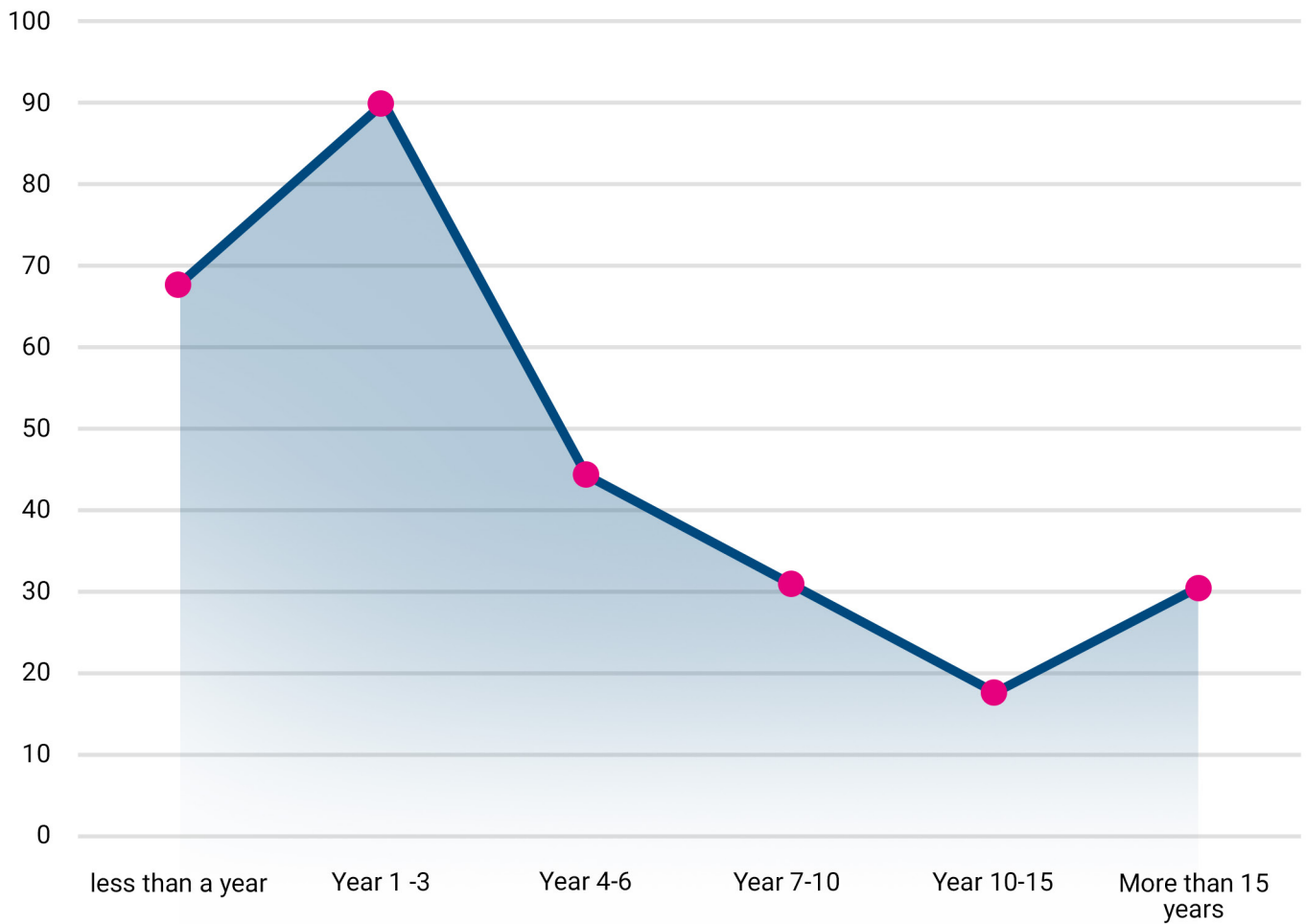


Characteristics of informal SMEs

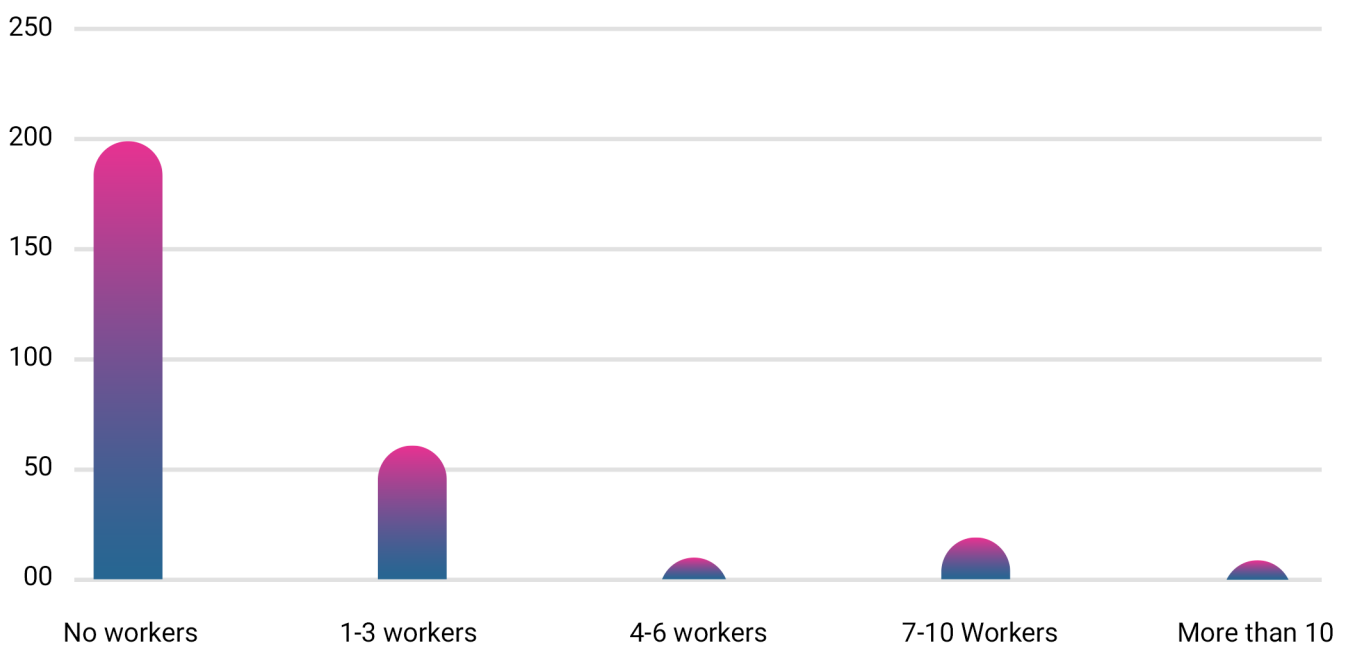
Age of the Business

The following line chart explains the age of the businesses which participated in this survey. The age of the business is taken as <1 year, 1-3 years, 4-6 years, 10-15 years and finally, more than 15 years. Most of the businesses are in the 1 to 3 years age category while the least number of participants businesses are in the 10 to 15 years age category. And the percentages are 32.1% and 6.1% respectively.

Age of the Business



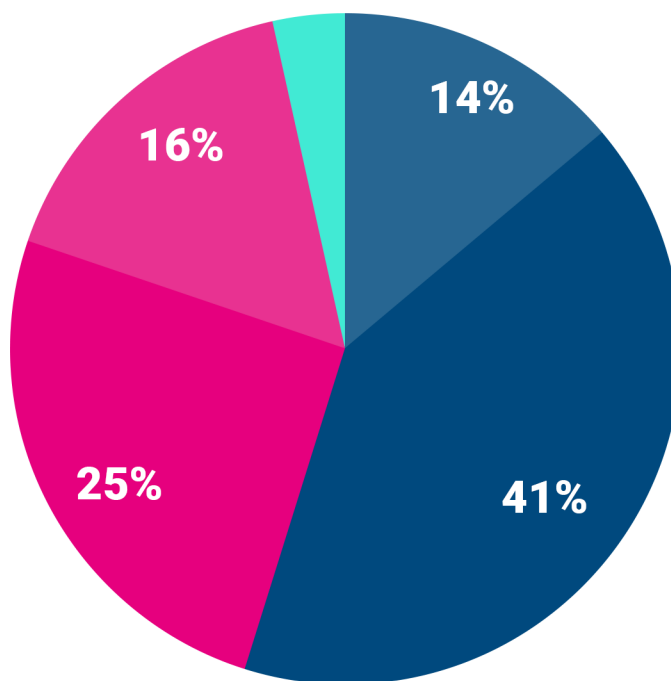
Number of Workers



This chart represents the number of workers employed in participants' businesses. More than 50% of the respondents do not have workers. While 60 of them have 1 to 3 workers. But only 1% of the respondents have more than 10 workers according to the above chart. The summary is as follows:

- 72.2% responded to No workers.
- 21.7% responded as 1-3 workers.
- 2.5% responded as 4-6 workers and 7-10 workers.

Age of the Owner

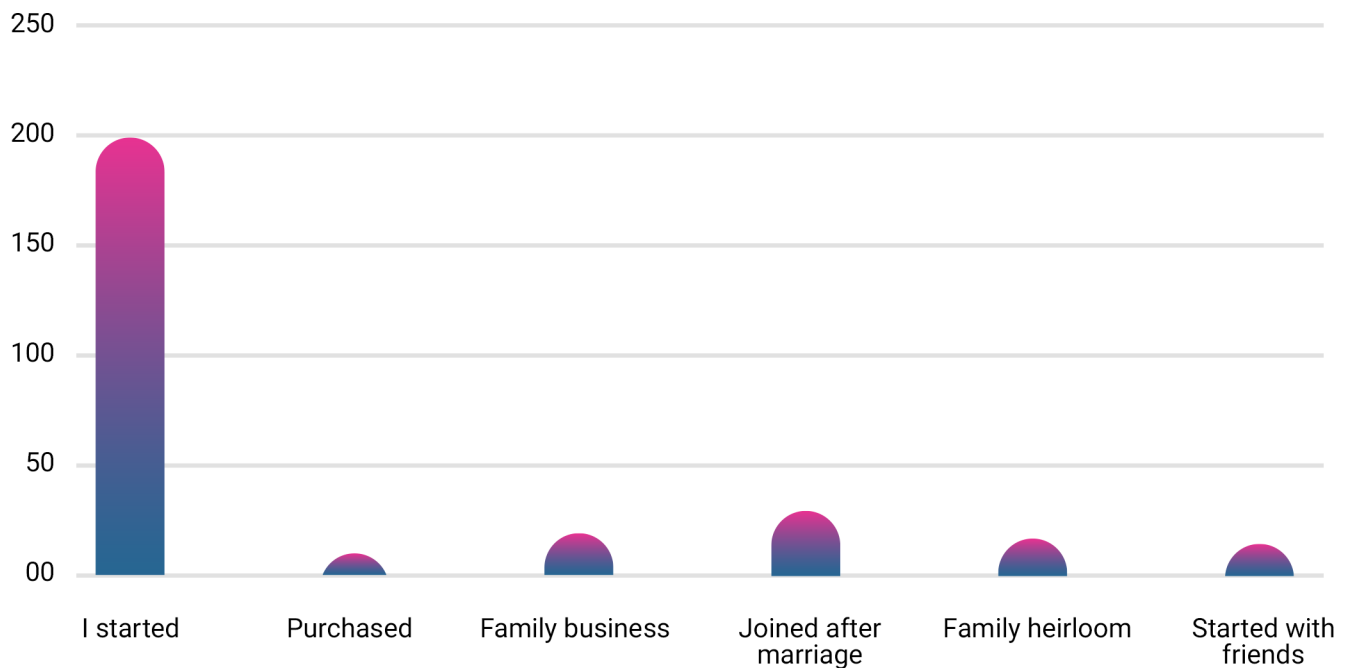


The above graph illustrates the age categories of the owners as follows:

- 114 participants are in the 31-40 age category.
- 70 participants are in the 41-50 age category.
- 45 participants are in the 51-60 age category.
- 38 participants are in the 18-30 age category.
- Only 3 respondents are in the above 60 age categories.

When considering the summary of the demographic profile, most of the owners are in the 31-40 age category. While the least number of owners are above 60 years old.

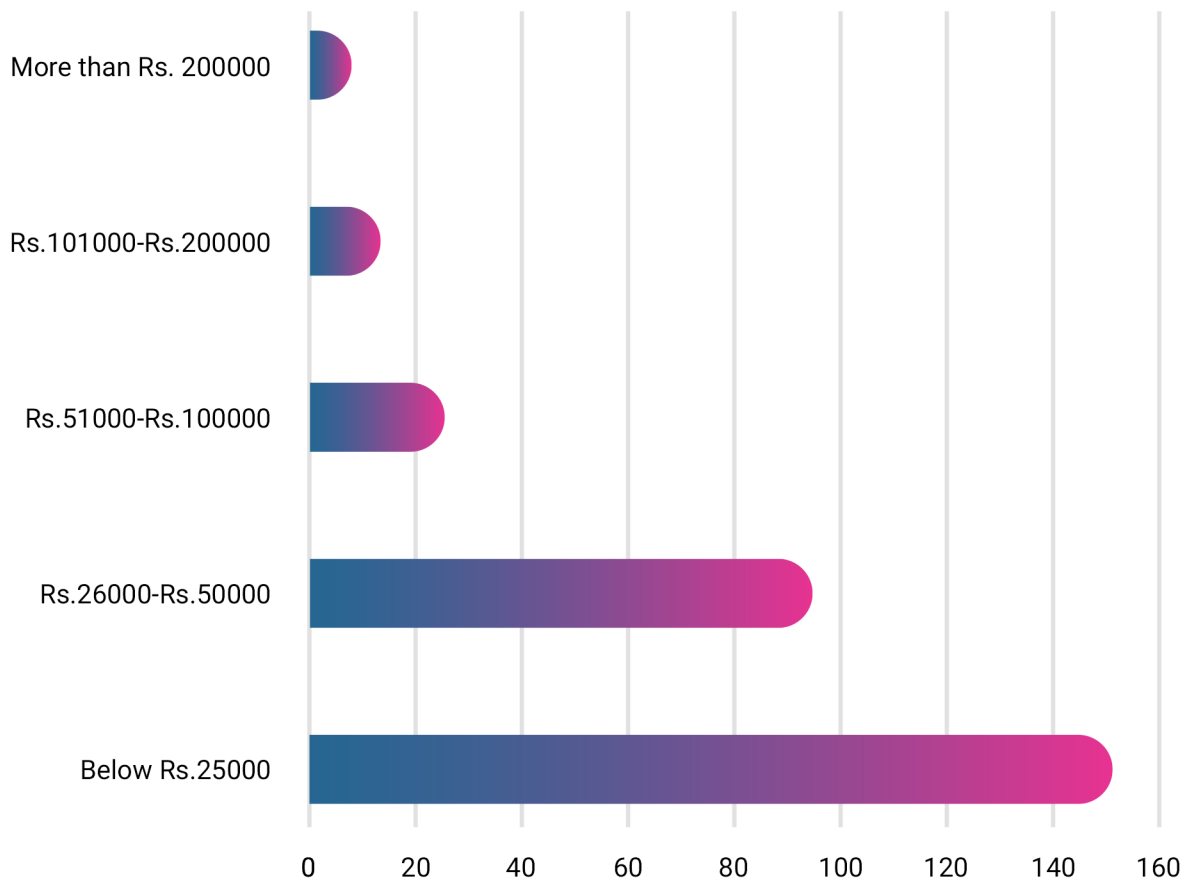
Start of the Business



Here respondents were asked to state how they started their businesses. The statements and the overall performance are as follows:

- 78% had started their businesses on their own.
- Only 5(1.8%) had purchased.
- 5.8% continue their family businesses.
- 16.5% had joined after the marriage.
- 4.3% owned as a family heirloom.
- 3.6% started their business with the partnership of friends.

Monthly average income



Outline of the monthly income of the respondent's business (select the income you earned before the Covid epidemic) as follows:

- 54.5% responded as < Rs.25,000
- 33.6% responded as Rs. 26,000-50,000
- 7.9% responded as Rs. 51,000-100,000
- 3.2% responded as Rs 101,000-200,000
- 0.7% responded as > Rs. 200,000

Reason/s to start the business

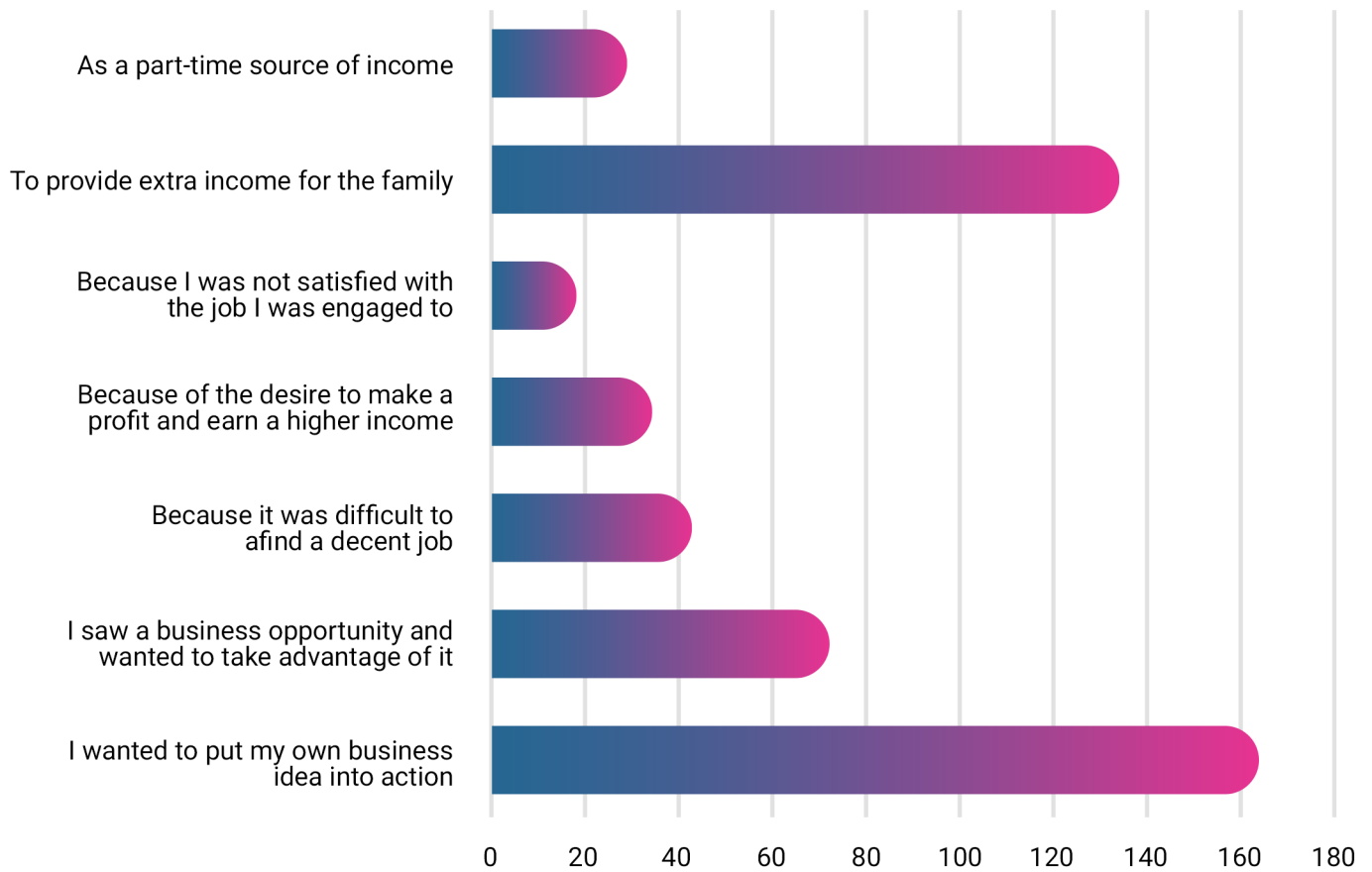
The following bar chart depicts the immediate reasons/s that influenced respondents to start the business. The summary is as follows:

- 58.5% stated that they wanted to implement their own business idea, as a part-time source of income for the family to earn extra income.
- 48% stated that they wanted to provide extra income for the family.

- 25.6% stated as that they saw a business opportunity and wanted to take advantage of it.

Less than 20% responded to the following statements:

- 14.8% stated as because it was difficult to find a decent job.
- 12.3% stated as a part-time source of income for the family to earn an extra income due to the need to make a profit and earn a higher income.
- 6.1% stated that they were not satisfied with the job engaged to.
- 9% stated as a part-time source of income



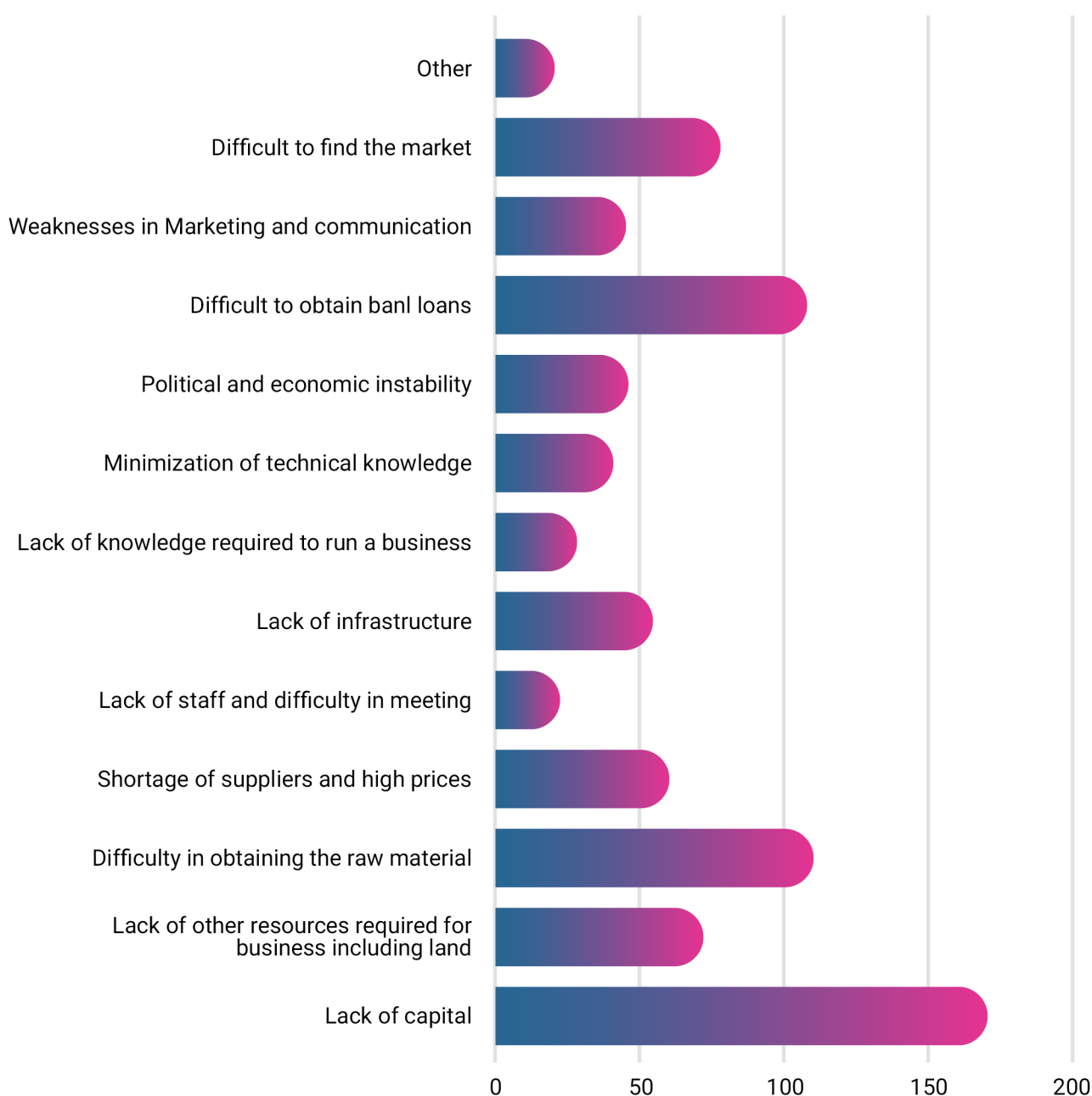
Common challenges

This survey looks at the challenges faced by the informal SME sector in Sri Lanka and the results are as follows,

- 57.8% stated that there is an issue in the capital.
- 38.3% stated that there is difficulty in obtaining bank loans.
- 37.9% stated that there is difficulty in obtaining raw materials.
- 28.9% stated that it is difficult to find the market.

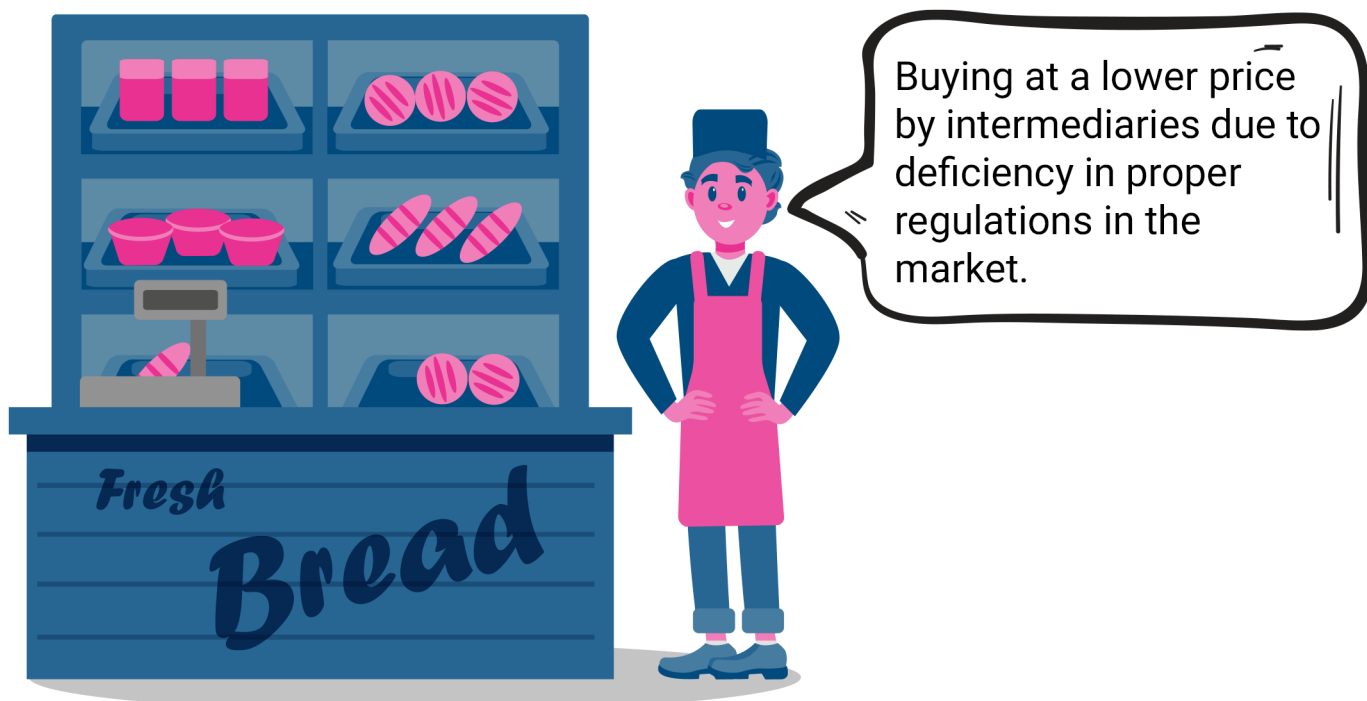
- 21.3% stated that there is a lack of required resources including land.
- 19.9% stated that there is a shortage in suppliers.
- 18.8% stated that there is a lack of infrastructure.
- 15.9% stated that there is a weakness in marketing and communication.
- 11.9% stated that there is political and economic instability.
- 11.2% stated that there is a deficiency in technical knowledge.
- 2.5% stated that there is difficulty in meeting and a lack of staff.

While 6.5% of the respondents stated as other.



Some of the businesses highly emphasized some issues as highly relevant challenges. Financing the business, marketing and promotion, tight regulations and lack of government support are the most highlighted areas among the other challenges.

Some of the statements as follows



Failure to inform and regulate the public sector, and inactivation due to non-regulation



Climate changes and fluctuations in prices.





Reasons for not registering the business



This chart depicts the reasons for not registering the business. The responses ratios are as follows:

- 57.8% to strict rules and regulations on registering.
- 28.9% to higher registration fees.
- 27.8% to the complexity of the registration process.
- 26.7% to pay income tax after registering.
- 11.2% to the complex inspection before and after registration.

Future Plans

The below chart represents the future plans of the respondents. The overall responses as follows:

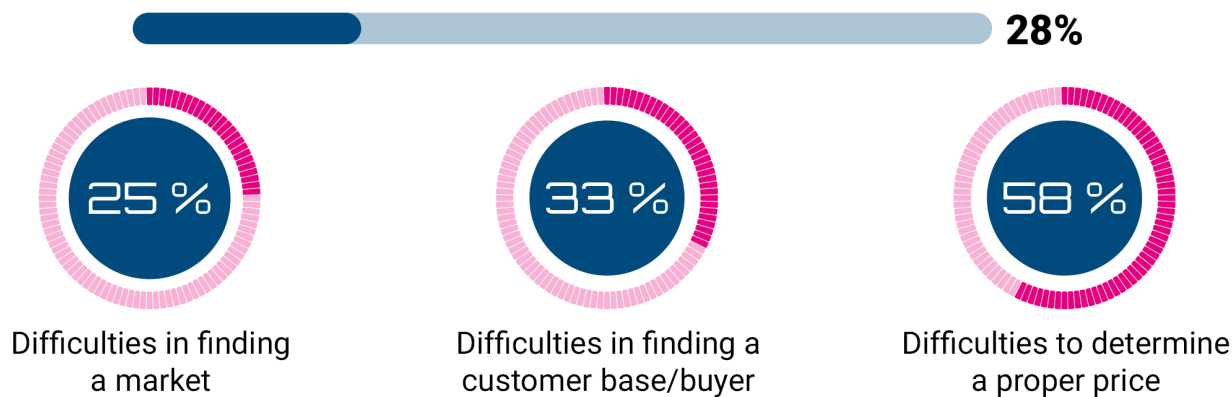
- 72.6% thinks to expand their businesses.
- 43% thinks to strengthen the business by finding other business opportunities related to their businesses.
- 38.6% thinks to register their businesses.
- 16.2% thinks to direct their businesses to another market.
- 11.2% thinks to start a new business.
- Only 0.7% thinks to close their businesses.



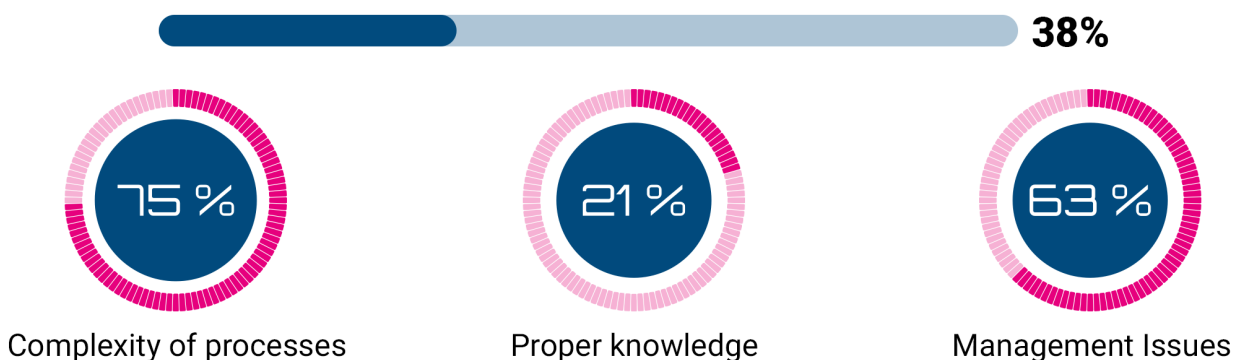
8.2 Qualitative data presentation

The study was continued further with 4 focus group discussions representing 4 districts in Sri Lanka. There were 6 participants in each group. Basically, the responses were received from Anuradhapura, Galle, Horana and Gampaha. These districts represent 3 main provinces as Western, Southern, and North Central Province in Sri Lanka. The following summary shows the developed themes and codes based on the transcribed data

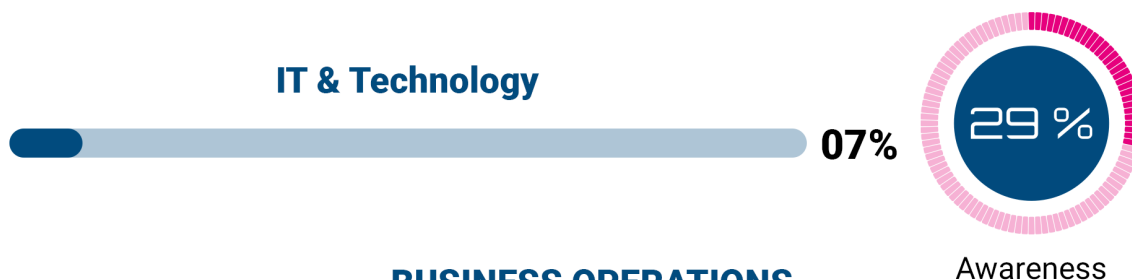
BUSINESS OPERATIONS



FINANCE & GENERAL MANAGEMENT



IT & Technology



BUSINESS OPERATIONS



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of the procedures followed in obtaining a loan, the high-interest rates involved, the difficulty in finding guarantors, and the lack of a proper income. Furthermore, the families of Sri Lankan public servants have been under some pressure due to the inability to obtain loans under the government concessionary loan interest scheme at any time.

As management challenges inability to pay salaries, difficulty maintaining a workplace on a rental basis, financial problems with the purchase of machinery and equipment, lack of financial facilities for packaging and distribution, and reluctance to pay for administrative sector activities, are pointed out primarily by the participants.

Lack of knowledge and experience in financial mechanisms and management is another major aspect they face. Hence, action is needed to change the informal SME sector in ways that help it thrive and acquire financial and management independence.

03. IT and Technology

Problems arising from product and factor markets, as well as the regulatory system in which they function, limit the transition and evolution of SMEs.

Challenges to address are access to capital, technological awareness, regulatory framework, access to information and guidance, market access, corporate development services, technical and management skills, relationship building and environmental issues. Other shortcomings include inadequacies in information technology and current technologies related to product design, packaging, distribution, and sales promotion. To make matters worse,

01. Business Operations

As per the results, there are three codes in which the likelihood of occurrence is high in business operations. The main challenges faced by the informal SME sector in business operations are the difficulties in finding a market, finding a customer base or buyers, and setting a proper price for their products and services.

There is no proper market, and that's the main reason behind the difficulties in finding a market. The conceptual factor that leads to a successful business is the compatibility of a product or service with a suitable market. It is a very crucial and challenging task.

The underlined element behind difficulties in finding a customer base or buyers is a lack of demand. Many factors determine this, like price levels, the type of product or service, income levels, and the availability of any potential substitutes.

The main reasons behind the difficulty in determining a proper price are difficulties in finding raw materials and high price of the materials. Market values are inherently dynamic because they depend on a combination of factors, from physical operating conditions to the economic climate to the dynamics of supply and demand. Therefore, businesses in the informal SME sector struggle to blend in with these factors and determine the proper price.

02. Financial & General Management

From individual perspectives about current economic models in Sri Lanka are failing to fulfill the financial and general management autonomy remains elusive. When it comes to financial challenges, basically the complexity of the procedures, lack of knowledge, and managerial issues, must be heard and heeded.

The main challenges in finance are the complexity

current commercial and regulatory costs are rising and creating unnecessary barriers. Due to the intense competitive pressure and the need for SMEs to enter the global market, proper and systematic use of Information Technology (IT) is a vital factor to reap significant benefits in the long run.

With the advent of commercialization, the widespread use of new information technology around the world can create new business opportunities. Today, information technology is a great help to SMEs to strengthen, compete and improve their productivity.

Therefore, government intervention is required to assist small and medium enterprises to successfully adopt the IT adoption process in practice.

04. Other macro environment factors

However, other macro-environmental factors also play a leading role in this. This is the main problem that arises when registering a business.

During our discussions, we discovered that they were unaware of the legal requirements for registering a business. Another factor is the complexity of the registration process; it's costly and time-consuming fact that even business owners very much dislike paying attention. In addition, many business owners say they are unaware that they need to register their business.

Another factor that has been confirmed is that there is a lack of government intervention, regulation, assistance, and support for SMEs. Thus, the government must take transformative action and seek to accomplish whatever the large business and civil society can do to help SMEs.

As in other macro-environment factors, the consequences of the climate and environmental crises also severely affect SMEs. Hence it is required to prioritize economic growth and social well-being using sustainable strategies

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to develop a convention framework to support SMEs.

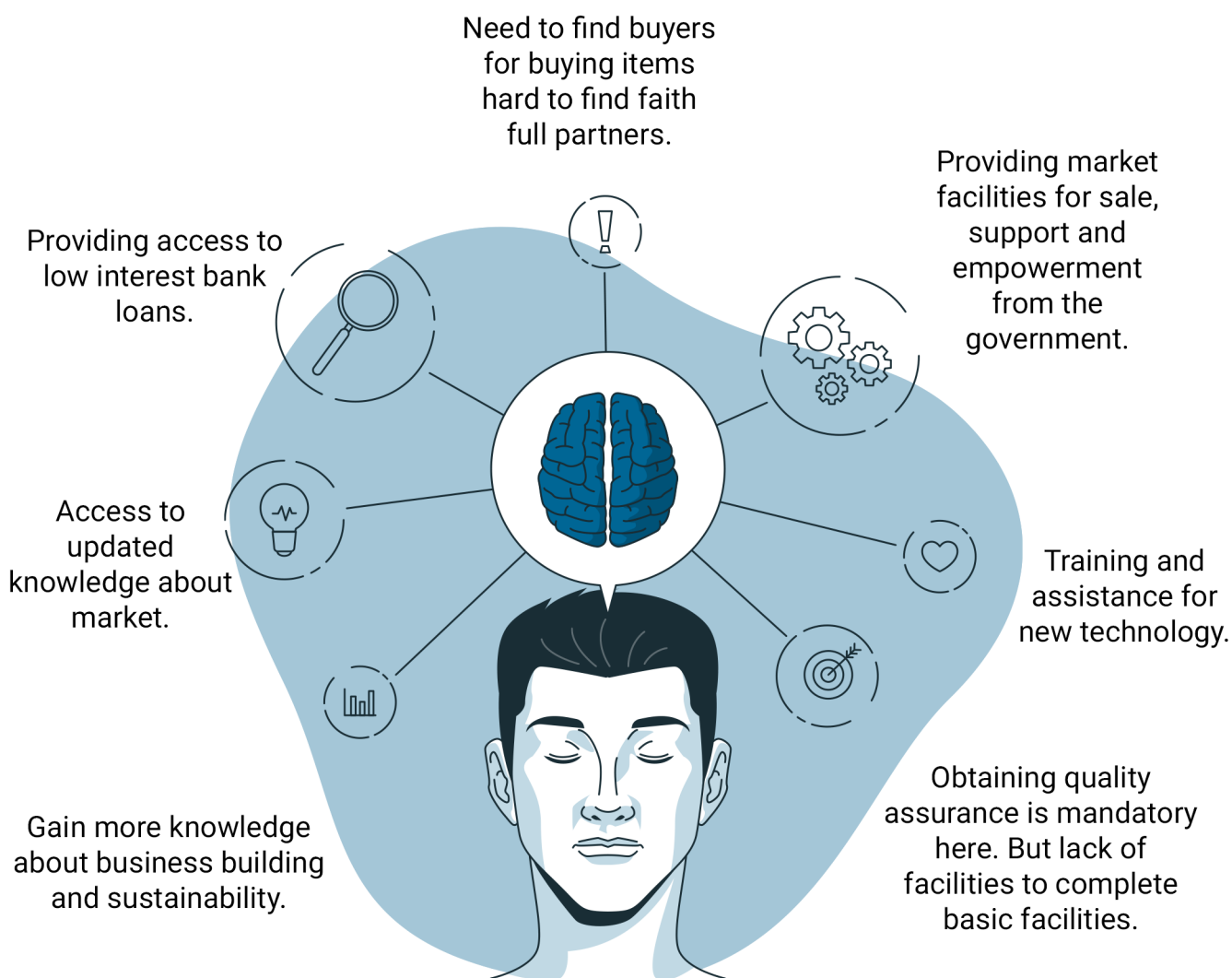
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Challenges to address are access to capital, technological awareness, regulatory framework, access to information and guidance, market access, corporate development services, technical and management skills.

09 | Recommendations

This survey and the focus group discussions were concluded by asking what support or suggestions they have to help them to grow their business. The overall suggestions are categorized as follows.



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