Is Formalisation Enough to Achieve Growth in SMEs?

Giancarlo Medroa Delgado
Faculty of Administrative and Economic Sciences, University of Lima, Peru

gmeddel@ulima.edu.pe

Abstract: The objective of this research is to determine whether the formalisation (FORM) of small and medium-sized enterprises (SMEs) has an impact on the growth, and determine which aspects of SMEs management, when formalised, are associated with and contribute to the growth of these organisations. A survey was applied to 403 proxies of SMEs in Lima, Peru. A structural equation model was used to validate the hypotheses. The results indicate that there is a positive and significant association between the FORM of SMEs management and the growth of these organisations. The main finding of this research is to determine that the formalisation of SME management in Lima, Peru explains their growth by only 27%, leaving 63% explained by other factors that could be not only management aspects, but also aspects of the SME environment. State institutions, companies and academia should analyse the low economic contribution of SMEs from a broader approach and not only from the position that formalisation is the only reason for growth. Other aspects should be studied, such as education in management issues by entrepreneurs, development of collaborators' competencies, improvement in the efficiency in the management of State institutions, among other factors; and thus, find the appropriate mechanisms that contribute to the growth of SMEs. This research is the first to analyse, in a single study, whether the formalisation aspects of SMEs management contribute to their growth. Finally, this research has contributed to the construction and conceptualisation of the SME growth variable.

Keywords: Management formalisation, Informality, Growth, SMEs, Emerging country

1. Introduction

SMEs are the main source of employment in emerging countries (Wang, 2016). However, the economic contribution of these organisations in terms of gross domestic product (GDP) is lower than in developed countries, employment conditions are not in line with labor regulations, and there are high levels of informality in their operations (Vasilescu, 2016). Despite efforts to strengthen the SME sector, these enterprises face several financial and regulatory barriers, especially in emerging countries (Berger and Udell, 1998). SMEs are of considerable economic importance in emerging economies and play an important role in the economic development of these countries; however, the performance of SMEs and the factors that contribute to this performance have received limited attention. The role of SMEs is critical to any country, but their declining contribution to GDP in recent years has been a cause for concern.

The phenomenon of unregistered businesses is a major global problem that has generated a great deal of attention in recent years. It is estimated that a substantial proportion of businesses around the world are not registered at the time of their creation, and an even larger percentage operate in the informal sector, evading reporting their production and sales to the authorities (Williams et al., 2017). This trend has sparked renewed interest in business research, with a specific focus on the challenges associated with operating in the informal sector (Krasniqi & Williams, 2020). The lack of comprehensive data on the number of unregistered businesses makes it difficult to obtain accurate figures. However, conservative estimates suggest that at least half of all businesses are unregistered, with approximately two-thirds of businesses operating without registration at the time of their creation (Williams & Liu, 2019).

In this context, promoting the formality of Peruvian SMEs is a major task for the economic development of the country; in this way it will be possible to reduce inequality and poverty levels (Williamson, 2009). Regarding the impact of entrepreneurs choosing to operate formally, numerous research has consistently shown that firms operating in the formal institutional environment tend to show superior efficiency and performance compared to those operating in informal institutional frameworks (La Porta and Schleifer, 2008). It is evident that new legitimate firms not only demonstrate higher revenues and profits, but also employ more workers and require more capital investment compared to their informal counterparts (Fajnzylber et al., 2011). In addition, studies indicate that registering firms to formalise them can improve firm performance compared to unregistered firms (Demenet et al., 2015).

In conclusion, although there is an extensive literature that explores the challenges faced by SMEs and the formalisation (FORM) of these companies in emerging countries, the evidence regarding the assured growth resulting from FORM is still incomplete, since the various studies only measure specific factors of FORM and growth, but not a more complete model that reflects the real context of regulation and management challenges that Peruvian SMEs are facing. As mentioned above, there is a great interest in analysing the

problems of SMEs to identify mechanisms and policies to promote their growth, and the same interest is perceived in the intention to formalise SMEs in emerging countries; previous studies have developed the analysis of the FORM and its advantages from specific aspects such as the payment of taxes, the registration of the company before government institutions, and the generation of contracts and recognition of payments with its collaborators; there is no previous evidence that, if the FORM at an integral level of SMEs guarantees their growth, there is also no evidence of which aspects of the FORM guarantee it.

In view of the above, the following research questions are posed:

- What factors are considered for SME FORM?
- What are the FORM factors associated with SME growth?
- Is FORM decisive and sufficient to achieve SME growth?

2. Literature Review

FORM of SMEs has been shown to have a positive and significant impact on several aspects of their performance. Studies have confirmed that after FORM, SMEs experience higher levels of revenue, profits, employment and capital intensity (Yazdanfar and Öhman, 2015). Formal SMEs have been found to provide a considerable number of employment opportunities and contribute significantly to GDP in high-income countries (Gombarume, 2014). Moreover, FORM has been positively correlated with firm performance, especially in terms of the probability of belonging to the group of growing firms (Kraus et al., 2006). In addition, the literature has highlighted the economic benefits associated with SME growth, such as improved productivity, employment generation, and increased tax-to-GDP ratios, which ultimately provide a competitive advantage to the economy (Khan et al., 2021). It has also been highlighted that SMEs play an important role in promoting rapid economic growth, and to the development and stability of many emerging economies (Karadag, 2015).

On the other hand, access to credit is a crucial element for SME growth (Ogoi, 2017). It has been confirmed that SMEs face significant difficulties in accessing credit, especially in developing countries, hindering their profitability and growth. The critical role of SMEs in driving the private sector and global economies suggests the importance of addressing the challenges they face in accessing credit. Previous studies have highlighted the impact of financial literacy, management competence, and overall business climate on SME performance (Agyapong and Attram, 2019). In addition, financial management practices, including working capital management, accounting information and financial reporting practices, as well as capital structure management, have been identified as influential factors on the growth and profitability of SMEs (Musah et al., 2018). The ability to access credit has been found to be influenced by factors such as collateral availability, financial literacy and payment capacity, which significantly affect the competitive growth of SMEs (Onkundi et al., 2023). In this regard, the importance of access to credit for SMEs and the various challenges they face in obtaining financing is evident. To facilitate the growth and sustainability of SMEs, it is essential to address these challenges, including improving financial literacy, collateral availability, and financial management practices.

SME learning processes are often informal and accidental, which may not contribute to their long-term sustainability. To solve this problem, it is proposed to apply knowledge-based learning methods that provide a formal structure for learning within these organisations. Furthermore, Valentim et al. (2015), confirmed the positive effects of formal learning in the learning process of inter-firm alliances, supporting the idea of incorporating formal learning structures in SMEs. On the other hand, the literature often suggests that the competitive advantage of smaller firms arises accidentally due to their informal management (Cagliano et al., 2001). However, it is essential to recognise that SMEs have unique constraints that impede their ability to actualise their learning (Saad et al., 2017). Therefore, formalising the learning process becomes crucial for their sustained growth and competitiveness. Moreover, the positive impact of inter-firm cooperation on the innovative performance of SMEs has been highlighted (Rezaei et al., 2014), which further increases the need for structured knowledge-based learning methods. This suggests that FORM of the learning process can improve organisational learning outcomes in SMEs, further supporting the need for structured learning methods in SMEs.

The use of intellectual property, such as patents, trademarks, copyrights and design registrations, has been the subject of interest in relation to SME growth. While some studies have found that patents do not necessarily lead to higher economic and financial performance of firms (Agostini et al., 2016), others have highlighted the positive influence of IP activities on SME performance (Andries and Faems, 2013). Moreover, it has been observed that SMEs tend to use their patents more actively than large firms, indicating a possible positive

impact on their performance. The FORM of these protection methods is indeed a costly process, especially for SMEs with limited resources; the high cost of formal protection methods, such as patent applications, coupled with low innovation output and patent-related uncertainty, often deters SMEs from investing in these mechanisms (Rehman and Yu, 2018). This is further supported by the fact that patents are expensive, leading SMEs to be selective in deciding whether patent protection is necessary. Trademark registration is cheaper to obtain than patents, making them a more feasible option for resource-constrained SMEs (Agostini et al., 2016).

3. Theoretical Framework

3.1 Growth of Small and Medium-Sized Enterprises

SME growth is a major research topic in emerging countries; however, there is no consensus in the literature on how to define and measure growth in these organisations (Tehseen et al., 2019). There are different theories and different methods used in the literature to measure growth; some analyses have developed theoretical constructs, others have used direct financial information from organisations, and others have used indicators validated by international organisations. Studies have estimated the growth of SMEs using variables created from data from the entrepreneurs themselves, such as the level of sales, market share, cash flow, and number of workers (Tehseen et al., 2019). SME growth is also analysed and measured using subjective perceptions of the entrepreneur, i.e., with only the entrepreneur's idea that his or her business is successful and growing (Chowdhury et al., 2013). On the other hand, other research has used direct information from the firm, such as growth in the level of sales using over a specific time (Macas et al., 2013). While there is controversy about the ways in which firm growth can be measured, there is a consensus on the factors that influence growth; according to the theory of firm growth proposed by Penrose (1959), growth depends on the application of managerial knowledge and entrepreneurial capabilities of firm leaders, and how this knowledge and capabilities are applied to their organisations.

3.2 Economic Formalisation of SMEs

Previous studies have presented some approximations to the criterion of informality, but there is still no consensus or single idea of how to define this phenomenon. The economic FORM of SMEs is the process for reducing informality. To identify the elements of the economic FORM, the concepts proposed by Gërxhani (2004) will be used; in this study it was possible to identify 5 common criteria within informal organisations. The economic criteria are the following:

- Unreported income or tax evasion. This criterion considers all taxable monetary income not declared for the purpose of tax evasion (Schneider and Enste, 2000).
- The labor market (undeclared jobs, lack of social benefit payments, sub-minimum wage payments, poor working conditions). Other studies have also emphasised this criterion (Harding and Jenkins, 1989).
- Size of the activity (size of the organisation in relation to the number of personnel hired). It is stated that an organisation with less than 10 workers is an informal organisation (Ferraro and Rojo, 2018).
- Professional status (measured by the number of self-employed, family workers and domestic workers). This criterion considers all workers in conditions of underemployment in these organisations (Hart, 1970).
- Regulation or registration of an activity (considers government regulation). This criterion considers unregistered and unlicensed establishments (Swaminathan, 1991).

3.3 Access to Formal Credit and Transparency of Financial Information

It is confirmed that access to credit facilitates the growth of SMEs and, therefore, is a fundamental element for these companies (Beck and Demirguc-Kunt, 2006). SME financing is a relevant aspect for the financial management of an organisation, SMEs resort to formal financing such as loans from regulated financial institutions, and informal financing such as loans from friends, relatives or informal moneylenders. Resorting to informal banking where financing costs are very high, affects the cost of capital of entrepreneurs (Wasiuzzaman and Nurdin, 2018); it has been found that, in developing countries, high interest costs of financing is an obstacle to the growth of SMEs (Wang, 2016). The decision to use formal credit in SMEs, and not informal credit, is influenced by the financial infrastructure and tax regulation of each country, i.e., the decision to use formal credit is also influenced by factors exogenous to management (Lin et al., 2020).

Additionally, there is a behavior in SMEs called Opacity of Financial Information (OIF); this practice of these companies for not generating financial and commercial information is linked to young companies (Hyytinen

and Pajarinen, 2008). The lack of information of SMEs affects their performance, not only because of the lack of financing, but also because the managers of these organisations do not have the necessary information for decision making (Sarapaivanich and Kotey, 2006); there is even a certain fear and lack of motivation on the part of the owners of these companies to apply for financing because they consider that they do not have enough information for a formal institution to finance them. It is stated that entrepreneurs owning SMEs, in their first years of operation, must try to make their information transparent, if they have the economic growth of their business as a goal (Zambaldi et al., 2011). Formal banking considers OFI as a risky behavior, there is evidence that confirms that the probability of defaulting on loans is higher for SMEs with higher OFI, this probability increases when these companies have a weak credit history (Gao et al., 2020).

For a formal institution to finance a company, it must have accounting and economic information; most SMEs, especially the smallest ones, do not have this information (Britzelmaier et al., 2013), which makes it difficult to measure the level of intrinsic risk. In some cases, not knowing the level of risk of SMEs, above-average financing costs are assigned to them; in Peru, the average SME financing cost rate is 32.9% (Choy et al., 2015). Initially, it was confirmed that the probability that banks are more willing to grant credit is positively related to the quality of accounting information (Palazuelos et al., 2018). However, when studies began to identify that this relationship is valid only for companies that have audited financial information, the lack of OFI was not a determining factor for accessing credit and better credit conditions; in these cases, trust between institutions was the determining factor for accessing credit and better credit conditions.

3.4 Formal Learning

Traditional training methods in the work environment must be questioned, studies confirm the importance of using competence development strategies that are based on an integration of formal and informal learning (Kock and Ellström, 2011). The learning theory points out 2 types of learning; the first is formal learning that is characterised by being a planned learning, certified and developed in courses provided in higher education institutions; and the second informal learning is the one that is learned in daily work activities, where learning is given by the active participation of workers in the organisation's projects, as well as the rotation of personnel within the organisation (Marsick and Watkins, 2016). Prioritising formal learning can undermine the spontaneous nature of learning, claims that one type of learning is better or worse than another should be avoided, both types of learning can be applied in organisations, both have advantages (Malcolm et al., 2003).

3.5 Formal Methods of Intellectual Protection

The literature indicates that another way to formalise organisations is through the FORM of different protection methods. Intellectual property represents knowledge that can be protected by recognised rights, called intellectual property rights (IPR) that encompass elements such as patents, trademarks, design and copyrights. There is extensive literature that studies the importance of IPR use in the performance of SMEs (Jensen and Ebster, 2006). It has been determined that the use of PM such as patents, trademarks, copyrights and design registration positively influence the growth of SMEs (Jensen and Ebster, 2006).

Considering the above, this research work formulates the following hypotheses.

H1: FORM is positively and significantly associated with SME growth.

H2: Labor FORM is positively and significantly associated with SME growth.

H3: Tax FORM is positively and significantly associated with SME growth.

H4: Financial transparency is positively and significantly associated with SME growth.

H5: Formal learning is positively and significantly associated with SME growth.

H6: The FORM of intellectual property rights is positively and significantly associated with the growth of SMEs.

4. Methodology

For SME growth, 5 items will be used such as growth in sales, growth in personnel, growth in facilities, growth in product and service offerings, and growth in customer base (Altinay et al., 2016). The Tax FORM (FT) which indicates whether the firm started paying one or more of the following taxes: corporate income tax; and/or, value added tax (Berkel et al., 2022). Labor FORM (FL) measured by a situation where workers have a declared job; workers have employment benefits from local regulation; minimum wages required by local regulation are respected; and good working conditions are available (Gërxhani, 2004). Transparency of financial information

(TIF) measured by 5 items such as: budgeting the company's fiscal year earnings; accuracy of earnings forecast; analysts' forecasts differ from each other (i.e., their diversity of forecasts, the less variation the more transparency); auditors' supervision; displaying the company's earnings flow (Maffett, 2012). Formal Learning (FL) measured by the investment of hours dedicated to activities such as conferences, seminars, workshops and trainings to a company's workers in the last year of operation (Froehlich et al., 2020). Formal protection rights (IPR) used by firms such as patents, inventions, design right, trademarks, and trade name right (Päällysaho and Kuusisto, 2016). Responses for the constructs were measured via binomial scale, under a 2-point scale (1 = meets, 0 = does not meet).

Table 1: Descriptive statistics

	Freq.	%		Freq.	%
Number of employees per company			**Industry**		
Less than 10	*187*	*46.4%*	*Commerce*	*223*	*55.3%*
Between 11 to 20	*50*	*12.4%*	*Accommodation and restaurants*	*71*	*17.6%*
Between 21 to 50	*166*	*41.2%*	*Telecommunications*	*38*	*9.4%*
Company's Operating Time			*Maintenance and repair*	*22*	*5.4%*
3 to 5 years	*260*	*64.5%*	*Construction*	*21*	*5.2%*
5 to 10 years	*67*	*16.6%*	*Transport, storage, mail and courier*	*10*	*2.5%*
More than 10 years	*76*	*18.9%*	*Others*	*18*	*4.6%*

5. Results

5.1 Validity and Reliability

The conceptual model (Figure 1) was tested using Smart PLS 4.0, a sophisticated and widely recognised software tool). To assess the efficacy and reliability of the model, a comprehensive evaluation was conducted, including measurement of item loadings, internal consistency, reliability, convergent validity, and discriminant validity. The detailed results of these evaluations are presented in detail in Tables 2 and 3, which provide an overview of the model's performance.

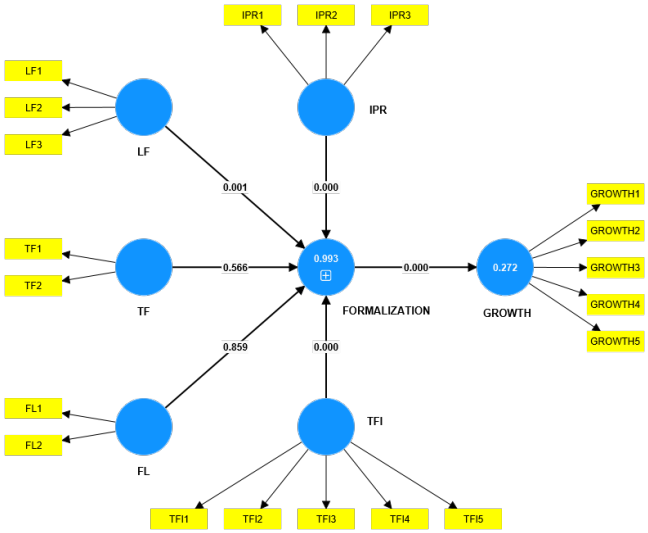

Figure 1: Structural Model

A crucial aspect that was examined during the evaluation was the loadings of the items used. It was observed that all item loadings exceeded the threshold of 0.50, which is considered statistically significant and indicative of convergent validity (Hair et al., 2014). This finding is very relevant and reinforces the validity of the model, as it demonstrates that the constructs investigated accurately measure the intended concepts.

Reliability was another important criterion evaluated in this study and was assessed using two widely accepted metrics: Cronbach's alpha and the composite reliability of the AVE. The results of these assessments revealed that the model exhibits a high level of reliability. Specifically, an AVE value equal to or greater than 0.5 and a

Cronbach's alpha indicator greater than 0.7 are considered indicative of an adequate model. In this case, all AVE values and Cronbach's alpha indicators exceeded these thresholds, which further reinforces the reliability and validity of the conceptual model investigated (Hair et al., 2014).

In addition to assessing the reliability and convergent validity of the model, an analysis was also performed to determine its discriminant validity. This analysis was intended to measure the differences between each construct and to assess whether they were distinct from each other. The results of the discriminant validity assessment were very encouraging, as they indicated that the square root of each AVE was greater than the correlations of the constructs.

Table 2: Measurement properties

Variable	Item	FL	Cronbach's alpha	CR (rho_a)	CR (rho_c)	(AVE)
Growth	GROWTH1	0.517	0.705	0.748	0.795	0.546
	GROWTH2	0.801				
	GROWTH3	0.810				
	GROWTH4	0.519				
	GROWTH5	0.632				
Laboral Formalisation	LF1	0.761	0.779	0.711	0.738	0.589
	LF2	0.769				
	LF3	0.545				
Tax Formalisation	TF1	0.774	0.706	0.707	0.771	0.627
	TF2	0.810				
Transparency of Financial Information	TFI1	0.672	0.721	0.738	0.717	0.544
	TFI2	0.731				
	TFI3	0.529				
	TFI4	0.565				
	TFI5	0.683				
Formal Learning	FL1	0.760	0.854	0.755	0.756	0.607
	FL2	0.798				
Intellectual Property Rights	IPR1	0.727	0.751	0.759	0.769	0.527
	IPR2	0.667				
	IPR3	0.779				

Note: Factor loading (FL), Average variance extracted (AVE), composite reliability (CR).

Table 3: Discriminant validity Fornell - Larcker analysis

	FL	GROWTH	IPR	LF	TF	TFI
FL	0.779					
GROWTH	0.208	0.668				
IPR	0.256	0.360	0.726			
LF	0.275	0.337	0.267	0.700		
TF	0.263	0.246	0.319	0.474	0.792	
TFI	0.401	0.432	0.373	0.387	0.390	0.587

Note: Formal Learning (FL), Average Intellectual Property Rights (IPR), Laboral Formalisation reliability (LF), Tax Formalisation (TF), Transparency of Financial Information (TFI).

5.2 Structural Equation Model and Hypothesis Testing

The coefficient of determination was 0.272 (see Figure 1), indicating a weak level of determination (Hair et al., 2014) generated by FORM. That is, there are other determinants for SME growth that will need to be the product of further research. The first hypothesis, H1, indicates that FORM has a positive and significant effect on GROWTH. Table 4 indicates that a positive and significant effect can be traced between the variables (β = 0.548; T-value = 15.060 and p = 0.000). Therefore, H1 should be accepted. The second hypothesis, H2, indicates that LF has a positive and significant effect with GROWTH. Table 4 indicates that a positive and significant effect can be traced between the variables (β = 0.355; T-value = 3.421 and p = 0.001). Therefore, H2 should be accepted. The third hypothesis, H3, indicates that TF has a positive and significant effect with GROWTH. Table 4 indicates that a negative and non-significant effect can be traced between the variables (β = -0.059; T-value = 0.575 and p = 0.566). Therefore, H3 must be rejected. The fourth hypothesis, H4, indicates that TFI has a positive and significant effect with GROWTH. Table 4 indicates that a positive and significant effect can be traced between the variables (β = 0.587; T-value = 6.107 and p = 0.000). Therefore, H4 should be accepted. The fifth hypothesis, H5, indicates that LF has a positive and significant effect with GROWTH. Table 4 indicates that a negative and non-significant effect can be traced between the variables (β = -0.017; T-value = 0.178 and p = 0.859). Therefore, H5 must be rejected. The sixth hypothesis, H6, indicates that IPR has a positive and significant effect with GROWTH. Table 4 indicates that a positive and significant effect can be traced between the variables (β = -0.017; T-value = 0.178 and p = 0.859). Therefore, H6 should be accepted.

Table 4: Hypothesis testing

	Coefficients	T-Value	p-Value	Hypothesis
FORM → GROWTH	0.548	15.060	0.000	H1 - Accepted
LF → GROWTH	0.355	3.421	0.001	H2 - Accepted
TF → GROWTH	-0.059	0.575	0.566	H3 - Not Accepted
TFI → GROWTH	0.587	6.107	0.000	H4 - Accepted
FL → GROWTH	-0.017	0.178	0.859	H5 - Not Accepted
IPR → GROWTH	0.416	4.763	0.000	H6 - Accepted

Note: Formal Learning (FL), Average Intellectual Property Rights (IPR), Laboral Formalisation reliability (LF), Tax Formalisation (TF), Transparency of Financial Information (TFI).

6. Discussion

The main finding of this research is to have determined that the formalisation of the management of SMEs in Lima, Peru determines their growth by only 27%, leaving 63% explained by other factors that could be not only management aspects but also aspects exogenous to the SMEs.

It was determined which specific management FORM factors contribute to the growth of SMEs. Among the most important, first and foremost, is TFI. TFI is among the most important management formalisation factors contributing to SME growth, as confirmed by the studies of (Tong and Serrasqueiro, 2020). It has been established that proper bookkeeping, financial reporting and management accounting practices are important for the survival of SMEs (Musah et al., 2018). Furthermore, the association between financial disclosure, transparency and firm performance has been found to be statistically significant, indicating that financial disclosure and transparency are significant determinants of SME performance (Musah and Padi, 2022). Formalisation of IPR, such as patents, trademarks, designs and copyrights, are confirmed to be specific management formalisation factors that contribute to the growth of SMEs, as could also be determined in the findings of (Jensen and Ebster, 2006). Trademarks play an important role in the growth of SMEs, as they are linked to the degree of product differentiation, product quality and overall firm performance (Agostini et al., 2015). Labor formalisation is confirmed to be one of the specific management formalisation factors contributing to SME growth; as stated in the study by (Dung et al., 2017) where he concludes that formalisation of labor relations can lead to increased productivity, improved working conditions and better access to finance; these aspects contribute to SME growth.

In addition, evidence has been found on the significant relationship between Tax Formalisation, Labor Formalisation, Registration Status, Transparency of Financial Information, Formal Learning and Intellectual Protection Methods, with the growth of SMEs. For example, the study findings (Ayyagari et al., 2007)

determined that labor formalisation, financial formalisation and registration formalisation are positively associated with SME growth; however, these relationships when measured separately fail to fully explain the dependent variable, i.e., they explain the growth variable in a weak way. Therefore, it is important to consider a holistic approach to SME growth that considers multiple factors, including formalisation in various areas, as well as other factors that contribute to SME growth.

On many occasions it has been stated that the main cause of the lack of growth of companies in Peru is the high level of informality; however, this research has contributed to shift the debate to other aspects of management, given that informality and, consequently, the formalisation of companies is not the main cause, or at least, it does not explain most of it. As supported by (Schneider and Enste, 2000) who affirms that there are other causes that can drive the growth of the informal economy in SMEs, such as higher taxes, high social security costs and government regulations.

Future research should focus on determining how formalisation is associated with other expected results of an organisation such as labor productivity, customer loyalty, business sustainability, among others. On the other hand, new studies should add efforts to determine what other factors generate the growth of SMEs and how these factors reinforce or correct the results of this research. Finally, future research can use the validated constructs of this research and apply them in other research related to business and economics.

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