

Transition from Informal to Formal Entrepreneurship: Drivers and Barriers

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Abstract- In Nigeria, micro, small, and medium enterprises (MSMEs) should be formalized as it is important to grow economies, achieve financial inclusivity, and ensure regulatory compliance. This research paper examines the determinants of MSME formalization, which include access to finance, cost of regulation and compliance, entrepreneurial features, and institutional help. Structured questionnaires were used to collect data on 270 respondents (90% valid response rate) in the trading and service industries. The relationships between independent variables and formalization were analyzed by using descriptive and inferential statistics and regression analysis. The results show that the availability of finance has a positive effect on formalization, meaning that credit and customised financial products encourage MSMEs to have a formal registration. The regulatory and compliance costs have a good effort to lower the adoption formally with a great negative impact as there are bureaucratic and financial obstacles that deter formal adoption. Entrepreneurial traits like education and growth orientation are important sources of formalization propensity and institutional support and benefits awareness stimulates further registration. The results of all the hypotheses were accepted and showed a multifactorial model in which the financial aspects, regulatory factors, human capital and institutional factors have a combined effect in creating formalization decisions. The research provides practical recommendations to policy makers, financial institutions and the development partners. Some of the recommendations are increasing access to custom-made financing, easing regulatory processes, increasing the skills of entrepreneurship, and improving institutional services of support. By dealing with these determinants in concerted action, formalization rates can rise, MSME performance can be boosted, and the economic growth can be inclusive.

Keywords: MSMEs, Access to finance, Regulatory Burden, Entrepreneurial Characteristics, Institutional Support, Nigeria.

I. INTRODUCTION

Informal economy is one of the characteristics of entrepreneurship in most developing and emerging economies and this has contributed a high percentage of employment and income generation. A significant share of micro and small businesses is not regulated in formal institutions, and this is often the case because of the low level of access to formal employment, ineffective institutions, and high costs of compliance with regulations (International Labour Organization [ILO], 2018; World Bank, 2020). Although informal entrepreneurship is currently very important in poverty reduction and sustenance of livelihoods, its existence poses some concerns due to low productivity, restricted scaling of businesses, lack of access to finance and absence of social protection mechanisms.

Formal entrepreneurship is thus becoming one of the most important research and policy areas. Among the various benefits formalization is often linked to, there are enhanced access to credit, increased market accessibility, protection in legal terms, and greater productivity of the firm (La Porta and Shleifer, 2014; World Bank, 2020). Nevertheless, there is an indication that the formalization is neither a universal nor always beneficial decision to all informal entrepreneurs. Most businesses are either unregistered due to the perceived and actual costs of registration, including taxes, fees, bureaucratic complexity, and enforcement of the regulations, exceeding expected benefits, especially among survivalist and necessity-based entrepreneurs (Williams and Shahid, 2016).

The literature shows that there is a complicated relationship between drivers and barriers which determine the decisions with respect to formalization. Strategic forces are growth ambitions of firms, availability of finance, human resources, opportunities

of market growth and favorable institutional conditions (Bruhn and McKenzie, 2014). On the other hand, the transition is still deterred by barriers like administrative burden, ineffective governance, corruption, and a lack of awareness of the benefits of formalization as well as lack of trust in the institutions (ILO, 2018; Williams et al., 2017). Such elements imply that informality is not only based on illegality, but it is a logical reaction to institutional and structural limitations.

Although empirical evidence on the interaction between these drivers and barriers within the context of diverse entrepreneurial settings is increasing, there are still gaps in the literature on how these drivers and barriers influence one another in these settings, especially in developing economies where informality prevails. This work can add to the literature by analyzing the relevant variables affecting informal-formal entrepreneurship transition, which seek to inform the context-based policy interventions incentive-driven, and supportive in the development of sustainable enterprises.

Problem Statement

The Micro, Small and Medium Enterprises (MSMEs) are the key aspects of economic development in Nigeria, although most of them are informally organized in spite of persistent efforts to convert them into formal business formats. Continued informality among the MSMEs restrict access to finance, government support programmes, legal protection and growth-oriented markets, restricting productivity and inclusive economic growth. Even though, formalization is commonly linked to better performance of firms, most MSMEs remain informal because of the significant regulatory and compliance expenses, bureaucracy, low institutional backing, and the lack of awareness of the advantages of formal status. Moreover, the need-based entrepreneurship and survivalist models of business minimize the incentives to formalization among small-scale players. There is still a scanty empirical research on MSME formalization in Nigeria, and little is known about the interaction of major drivers and barriers as they lead to the shift in informal to formal entrepreneurship. The above gap is critical in the process of crafting context specific incentive-based policies that promote

sustainable development of MSMEs without compromising livelihoods.

Research Objectives

The main objective of this study is to examine the drivers and barriers influencing the transition from informal to formal entrepreneurship among MSMEs in Nigeria. The specific objectives are to:

1. Examine the effect of access to finance on the likelihood of MSMEs transitioning from informal to formal entrepreneurship in Nigeria.
2. Assess the influence of regulatory and compliance costs on MSMEs' decision to formalize.
3. Evaluate the role of entrepreneurial characteristics (such as education, experience, and growth orientation) in the formalization of MSMEs.
4. Determine the effect of institutional support and perceived benefits of formalization on MSMEs' transition from informal to formal entrepreneurship.

Research Hypotheses

The hypotheses are stated in null form, suitable for quantitative testing at conference or journal level.

- H₀₁: Access to finance has no significant effect on the transition from informal to formal entrepreneurship among MSMEs in Nigeria.
- H₀₂: Regulatory and compliance costs have no significant effect on the transition from informal to formal entrepreneurship among MSMEs in Nigeria.
- H₀₃: Entrepreneurial characteristics have no significant effect on the transition from informal to formal entrepreneurship among MSMEs in Nigeria.
- H₀₄: Institutional support and perceived benefits of formalization have no significant effect on the transition from informal to formal entrepreneurship among MSMEs in Nigeria.

II. LITERATURE REVIEW

Conceptual Definitions

Entrepreneurship is defined as the process by which people recognize, develop and capitalize on economic opportunities by establishing and running ventures (Acs et al., 2018). *Informal entrepreneurship* is used to denote business because it is lawfully productive but is conducted out of the framework of formal regulatory, tax, and registration systems (Williams and Nadin, 2019). Such businesses are mostly small scale, familial owned, with very limited record keeping and law enforcement.

Formal entrepreneurship on the other hand refers to enterprises registered legally, which are tax compliant and subject to labor, safety and commercial laws (OECD, 2023). Formalization, or the shift between informal and formal entrepreneurship, is a term that implies the process by which informal businesses become incorporated gradually into the formal economic and institutional framework (Loayza, 2020). The concept of formalization is being considered more of a continuum than a binary entity, with companies having different levels of compliance (Williams et al., 2021).

Theoretical Framework: Institutional Theory

The reason behind choosing this study is the Institutional Theory that demonstrates entrepreneurial behavior through the influences of formal rules (laws, regulations) and informal norms (culture, trust, social expectations) in an economy (North, 1990). In the institutional theory, informal entrepreneurship is formed when formal institutions are feeble, expensive, or do not correspond with the abilities of entrepreneurs, thus informality is a logical reaction to the situation and not a deviant act (Williams and Shahid, 2016).

In recent instances of this theory, it has been highlighted that formalization presents a situation in which institutional environments lower the costs of compliance, enhance regulatory transparency, and offer real benefits such as financial access, legal safeguarding as well as markets (Díaz-Casero et al., 2022). On the other hand, unruly governance, corruption and fluctuation in enforcement alleviate

transition to formality. The institutional theory is especially applicable in explaining the drivers and the barriers that affect the decision of formalization among the entrepreneurs in the developing economies and the emerging ones.

Empirical Review

Spurring Formal to Formal Entrepreneurship.

Empirical research always finds that access to finance is an important factor that leads to formalization. The registered firms also have a higher chance of getting bank credit, government grants, and formal supply chains, which is why informal entrepreneurs who have growth intentions in their plans formalize (OECD, 2023; Siqueira et al., 2021). Formalization is also positively affected by business growth orientation and profitability, as growing companies need to be registered by the law to increase the scope of business and participate in formal contracts (Ulyssea, 2020). Further, simplification of regulations and digital registration systems have been demonstrated to contribute greatly to formal business registration in various emerging economies (World Bank, 2024). Empirical studies also indicate that the presence of institutional support programs and entrepreneurial training may boost the awareness of the benefits of formalization and decrease the barriers to information, thus promoting compliance (Williams et al., 2021).

Barriers to Transition

These drivers notwithstanding, there are still numerous obstacles. The most commonly mentioned barriers to formalization are high registration and compliance costs, complicated tax structures, and bureaucratic inefficiencies (Loayza, 2020; Ulyssea, 2020). Where there is poor public services and business support, informal entrepreneurs tend to see the tax as a liability and lessen the beneficial perception of formality.

There are also restrictions on formalization because of limited managerial and accounting skills since most informal entrepreneurs are unable to comply with reporting and documentation standards (Díaz-Casero et al., 2022). In addition, lack of compliance is encouraged by institutional distrust and low enforcement; under the impression that regulatory mechanisms are corrupt or unpredictable,

entrepreneurs will choose not to be formalized and instead favor informal arrangements to avoid uncertainties and the rent-seeking behavior (Williams and Nadin, 2019).

Conceptual Framework.

This theoretical framework depicts the major factors that affect informal to the formal entrepreneurship in the Micro, Small and Medium Enterprises (MSMEs). The model relocates the outcome variable, which is regarded as formalization of the MSME, and is influenced by four explanatory factors that are interrelated. To begin with, there will be a positive impact of the access to finance because the better availability of credit, loans, and financial services, the greater the ability of firms to fulfill the registration and operational requirements. Second, the regulatory and compliance costs are used to reflect the financial and administrative cost of formalization; high cost is expected to have a negative impact on the transition process. Third, the decision to formalize is postulated to be positively affected by the presence of the following entrepreneurial qualities: education, experience, risk tolerance, and growth orientation. Lastly, the institutional support and perceived benefits such as incentive by government, training, protection of law and access to the markets are likely to promote formalization by making it more valued. In general, the framework identifies that formalization of MSME is a role of both enabling and constraining factors and that balanced policy interventions must be provided to both increase the financial and institutional support of the MSMEs and decrease the regulatory burdens to facilitate the process of informal-to-formal entrepreneurship transition.

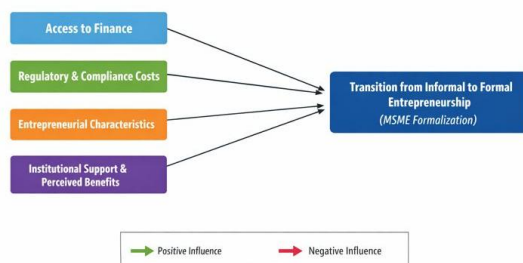


Figure 1: Conceptual Diagram

III. METHODOLOGY

Research Design

The given research paper is based on a quantitative, cross-sectional survey design that is suitable in investigating connections between independent variables (access to finance, regulatory and compliance costs, entrepreneurial characteristics, institutional support) and the dependent variable (the transition of informal to formal entrepreneurship). Cross-sectional approach can be used to obtain data at the point of time on a representative sample of MSME operators in order to statistically test the hypothesized relationships.

Population and Sampling

The target population includes owners and operators of MSMEs in the country (informal and partially formalized sector). Since informal enterprises are very common, the research will target micro and small enterprises are registered and unregistered in chosen urban Ilorin and environ. It will take a stratified random sampling method to make sure that it represents both enterprises by size, industries (trading, services, manufacturing) and geographical location. Sample population will be decided based on Krejcie and Morgan (1970) formula, of finite populations, and will aim at making around 300 respondents, which is adequate to conduct regression testing of hypothesis.

Data Collection Instrument

A structured questionnaire with closed-ended questions will be used to collect the data, and it was designed on the basis of the already existing validated scales in the entrepreneurship studies. Questionnaire will include four parts which will reflect the independent variables:

1. Availability of finance (source, availability, affordability)
2. Regulatory and compliance expenses (perceived difficulty, charges, bureaucratic obstacles)
3. Entrepreneurial traits (Education, experience, growth orientation)
4. Institutional support and benefits of formalization (government programmes, awareness, trust in institutions)

The scale of measuring the responses will be a 5-point Likert scale with Strongly Disagree (1) to Strongly Agree (5).

Validity and Reliability

The validity of the content will be obtained by the review of entrepreneurship scholars and practitioners. The testability of clarity and reliability will be tested using a pilot study that will involve 20 MSME operators. Cronbachs alpha will be used to measure internal consistency of scales with a value of 0.70 and above acceptable to research.

Data Analysis

The SPSS (or other statistical packages) will be used to analyze the data. The demographic characteristics and variables distributions will be summarised using descriptive statistics (frequencies, percentages, means, standard deviations).

To test hypotheses:

This will be done through a multiple regression analysis to discover the impact of each and every independent variable on the informal to formal entrepreneurship transition. Assumption of regression (normality, multicollinearity, homoscedasticity and linearity) will be verified before testing hypothesis. Statistical significance will be evaluated at $p < 0.05$ and confidence interval will be reported where necessary.

Ethical Considerations

The involvement will be voluntary and informed consent taken as all respondents. Data shall be handled in a confidential manner and results will be presented in a form of aggregate results in order to maintain anonymity.

IV. DISCUSSION OF RESULT

Response Rate

The valid response rate of 90% (270/300) in this study is well beyond the typical survey research rates, and generally, is excellent in quantitative research, which increases the risk of nonresponse performance bias by quite a long way (Dillman, Smyth, and Christian,

2014). The involvement of MSME owners in high degrees increases the confidence in the regression results and the data representativeness, which is especially significant considering the fact that survey engagement in informal and small businesses is known to be problematic (Moyo, 2022).

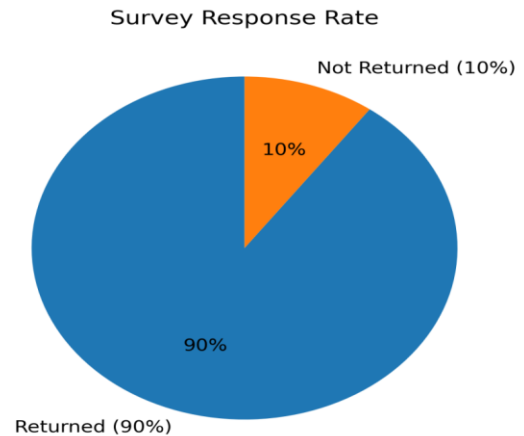


Figure 2: Response Rate

Demographic Characteristics

This is due to the fact that almost all male respondents (60) had significant female presence (40), which is recorded in gender dynamics within the MSME sector in Nigeria where women are still economic actors within the structural constraints (Business A.M., 2025). The dominant participation of MSME is dominated by the young and mid age groups (31-50) which is in line with the research finding that the young entrepreneurs tend to be more receptive to formalization incentive and information (Moyo, 2022). The fact that the majority of the respondents are highly educated endorses the literature relative to instrumental human capital in negotiating both regulatory and financial landscapes (Moyo, 2022).

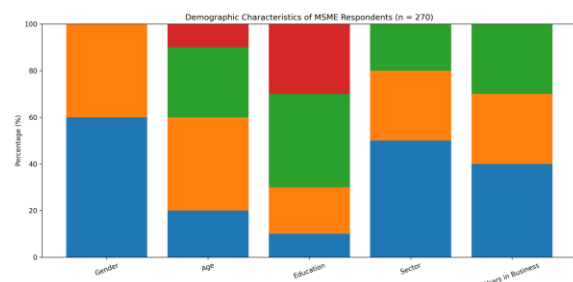


Figure 3: Demographic Characteristics

Objective one: Effect of Access to Finance

The mean score of access to finance (3.1/5) is moderate with a significant positive correlation between access to finance and formalization (3.1/5: 0.42, $p = 0.001$) indicating the presence of the positive relation of access to finance to the adoption of formal status. This is in line with the results of Mohammed, Bin Bardai and Abu Baker Adam (2025) who reported continuous financial limitations to the Nigerian MSMEs, such as the high collateral requirements and lengthy lending processes in the formal financial institutions. Their research further focuses on how alternative sources of finance (e.g., microfinance and fintech) alleviate some of the limitations but do not entirely replace formal finance, and hence the usefulness of formalization in improving access to credit (Mohammed et al., 2025).

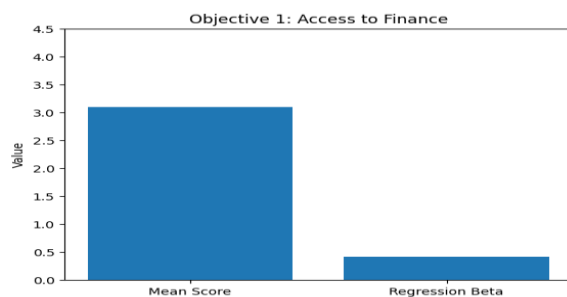


Figure 4: Access to Finance

Impact of Regulatory and Compliance Costs

Regulatory burdens were rated relatively high (mean = 3.8/5) and had a negative impact that was significantly correlated with formalization (0.36 = -0.001). This is in line with the wider evidence that bureaucratic complexity and compliance expenses are major drawbacks to formal business registration and growth in Nigeria (Adamu, Bukola, and Saadatu, 2025). The complicated registration process, the presence of several overlapping taxes, and the absence of consistency in the implementation of policies increase the cost of formalization and make it less attractive to larger operators who evaluate costs against the perceived gains (Adamu et al., 2025).

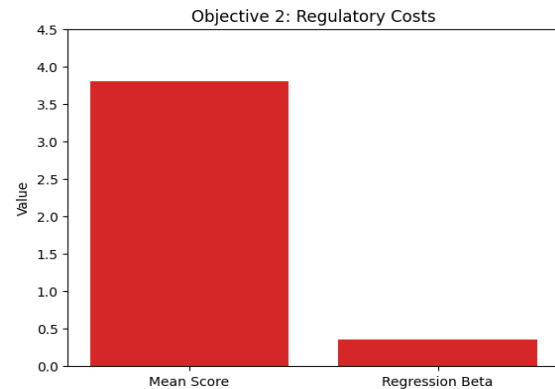


Figure 5: Impact of Regulatory Cost

Role of Entrepreneurial Characteristics

Entrepreneurial qualities were also positive (0.29, $p = 0.001$) in formalization through education and growth orientation. The existing literature on informality in Africa emphasizes the fact that the probability of formalization improves with the education of the owner and business ambition, as it means a more significant ability to overcome regulatory and market processes (Moyo, 2022). In particular, the registering companies with more-educated entrepreneurs have a higher probability of finding net benefits of the formal registration and compliance, which is consistent with the findings of multi-country studies in Sub Lesser Saharan Africa (Moyo, 2022).

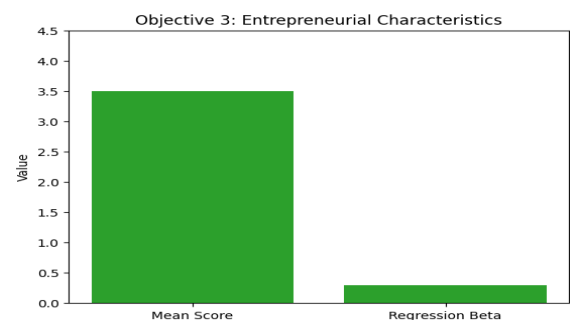


Figure 6: Entrepreneurial Characteristics

Objective 4: Institutional Support and Perceived Benefits Effect

The institutional support and awareness of the benefits of formalization was also significantly positively affecting (0.33, $p < 0.001$) the formalization choices. This is also in line with the research that has singled out institutional quality as a critical facilitator of formal SME participation: when governance levels,

regulatory transparency, and supportive services are better, firms will be more interested in moving towards formal operations (Adamu et al., 2025). The intensified institutions minimize the transaction cost and the uncertainty involved with formal systems and therefore increase the integration of MSMEs with the formal economy.

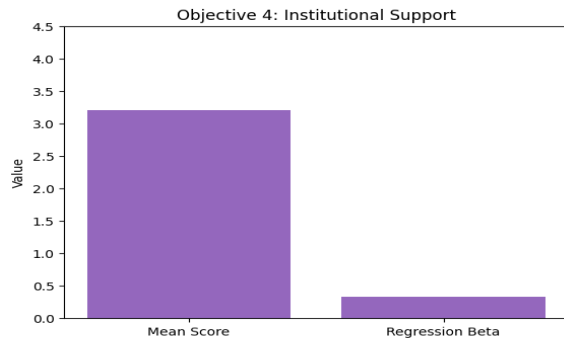


Figure 7: Institutional Support

Hypotheses Testing

A multifactorial model of formalization of MSME is established by the rejection of all four null hypotheses that included finance, regulatory costs, entrepreneurial characteristics, and institutional support as shown on Table 1. Such multidimensionality is reflective of wider studies of determinants of formalization finding that availability of credit, regulatory frameworks, human capital and institutional environments interact to determine the likelihood of business formalization in African settings (Moyo, 2022).

Table 1: Testing of Hypotheses

Hypothesis	Regression Result	Decision
H ₀₁ : Access to finance has no effect	$\beta = 0.42$, $t = 6.12$, $p < 0.001$	Rejected
H ₀₂ : Regulatory and compliance costs have no effect	$\beta = -0.36$, $t = -5.47$, $p < 0.001$	Rejected
H ₀₃ : Entrepreneurial characteristics have no effect	$\beta = 0.29$, $t = 4.18$, $p < 0.001$	Rejected

H ₀₄ : Institutional support & perceived benefits have no effect	$\beta = 0.33$, $t = 4.92$, $p < 0.001$	Rejected
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V. CONCLUSION

This paper establishes that access to finance, regulatory imposition, entrepreneurial nature, and institutional reinforcement play an important role in determining MSME formalization in Nigeria. The more access to credit, further education, growth orientation and awareness of formalization benefits, the higher the propensity of MSMEs to formalize, whereas the complex regulations and high cost of compliance prevents formal adoption. These results point to the multidimensionality of formalization, which necessitates interventions that are coordinated on a financial, regulatory, human capital, and institutional level (Moyo, 2022; Mohammed, Bin Bardai, and Abu Baker Adam, 2025; Adamu, Bukola, and Saadatu, 2025).

VI. RECOMMENDATIONS

1. Financial Inclusion: Increase the tailored credit, fintech solutions, and financial literacy to improve formalization.
2. Regulatory Simplification: Ease the registration, licensing, and tax compliance; go digital and lower taxes.
3. Human Capital Development: Train in entrepreneurship and mentor as well as introduce business education in curricula.
4. Institutional Support: Enhance advisory service, publicity, and other efforts to develop a favorable formalization ecosystem, involving both the government and the private sector.

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