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POLICY REFORM AND THE INFORMAL SECTOR IN AFRICA

by

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POLICY REFORM AND THE INFORMAL SECTOR IN AFRICA

Much has been written about the role and potential of the informal sector in third world countries. After a large number of studies undertaken on this topic during the 1970's, often under the auspices of the International Labor Organization, interest in the concept waned, partly as a result of a widespread disillusionment with it as an analytical construct. The term has recently been subject to renewed interest and change of focus; the writings of Dr. Hernando de Soto have played an important role in this renewal of interest.[1]

This paper has four parts. The first provides a brief review of the principal dimensions of the economies of Sub-Saharan Africa which form the context in which informal enterprises operate on that continent. Secondly, we look specifically at the informal producers in Africa to explore their characteristics and to address questions of desirable patterns of growth for these enterprises. The third section looks at policies: what types of policy changes are called for to move the economy (including the informal producers) in desirable directions? What types of policy change have and have not worked in this regard? A fourth set of issues concerns the extent to which Africa is like or unlike the picture drawn for Peru by Dr. de Soto. What lessons can be learned from his analysis of the situation in Lima, what modifications in that analysis are required to adapt them to Africa? This question forms the underlying motif throughout the paper; some summary ideas in this regard are presented in section four.

I. <u>The African economic context</u>. There are a number of characteristics of African economies which have important implications for the informal sector on that continent.

1.1. The fact of diversity: Africa is a highly diverse continent. GDP/capita in Botswana or the Congo is more than five times the level in Burkina Faso or Zaire. Rural population densities in Rwanda and Malawi are more than ten times those of Cote d'Ivoire or Zimbabwe. There are few valid generalizations which apply to Africa as a whole. The challenge is to see what common themes can be found in the midst of that diversity.

[1] See, for example, his <u>The Other Path: The Invisible Revolution in the Third World</u> (New York: Harper and Rowe, Publishers, 1989); "The Informals Pose an Answer to Marx," <u>The Washington Quarterly</u>, Winter 1989, pp. 165-172; and the presentations and discussion in Jerry Jenkins, ed., <u>Beyond the Informal Sector: Including the Excluded in Developing Countries</u> (San Francisco: Institute for Contemporary Studies Press, 1988).

1.2. Low income: nineteen of the world's poorest twenty-five countries (measured in terms of GDP/capita) are in Africa. Equally important is the size of aggregate GDP; of the 33 countries in Sub-Saharan Africa for which such data are available, in 26 of these, the total GDP was less than $5 billion (1986 figures). The comparable official figure for Peru was over $25 billion. These are not only poor countries but small markets as well.

1.3. Mostly rural. Of the 34 countries with relevant data, in 21, more than 70% of the population lives in rural areas; in 29 countries, the figure is more than 60%. For most of these countries, then, the urban explosion which is central to the "Lima experience" of which Dr. de Soto speaks is still in its very early stages (although it is also true that urban growth rates in Africa are among the highest in the world).

1.4. Low population density, especially in rural areas. With few exceptions (Rwanda, Burundi, Malawi), the rural population is widely dispersed. This is dramatically different from low-income Asia (India, Bangladesh, etc.), perhaps less different from Latin America.

1.5. Poor infrastructure: There are few roads per square kilometer, a relatively weak transport and communications network, and limited availability of water, electricity and telephones, particularly in rural areas.

1.6. Largely as a result of low levels of per capita income, a large share of consumption is focused on food. This further limits the size of the market for non-food products.

1.7. Agriculture is growing only slowly. Over the period 1980-86, of the 32 African countries for which the World Bank publishes such data, in 29, agricultural production grew less rapidly than population. In 13 of those 29, the decline in agricultural output per capita was greater than 2% per year.[2]

1.8. Low investments in human capital. Adult illiteracy is widespread (well over 50% in more than half the countries of Sub-Saharan Africa). While universal primary education is coming to

[2] A recent World Bank/UNDP study reported a substantially better agricultural performance in Africa for 1985-88. The results are based on preliminary FAO data. While recognizing the weaknesses of these preliminary data sources and the influence of weather on such short-term agricultural trends, one can hope that the authors are correct in interpreting this as reflecting the impact of better policies. See Africa's Adjustment and Growth in the 1980's, February, 1989.

be more widespread, still less than half the countries of the region have reached that goal. Only a small share of the relevant age group is currently enrolled in secondary school.[3]

In sum, while recognizing the diversity that exists on the continent, one finds that a majority of the countries in Sub-Saharan Africa are characterized by very small national markets, particularly for non-food products. The rural orientation, low population density and poorly developed infrastructure mean that in addition to being small, these markets are often widely dispersed and seriously fragmented. The economies are dominated by agricultural sectors that are growing only slowly if at all, which means that demand in these markets is far from dynamic. Investment in physical and human capital is low. All these factors make clear that the context in which informal enterprises operate is a very difficult one.

II. Informal enterprises. Much has been said and written about the difficulty of agreeing on a precise definition of the term, informal sector. In my own work in the past, I have avoided using the term. It means too many different things, most of them not very precise, to those who use it. For the purposes of this paper and conference, I assume that we are following one of these definitions, that of Dr. de Soto: informal enterprises are those that operate outside of government regulations. We recognize, as he has, that this is not an all-or-nothing question but one of degree. If we use words precisely, we recognize that there is no such thing as an informal sector; there are informal producers in many sectors of the economy.

By definition, then, these enterprises are unregulated; in general, they are also unrecognized by the government. It is not surprising, then, that data about them, specially from official sources, are very weak. Information must reach beyond official statistics to academic research, studies done by aid organizations, or projects aimed at the development of particular districts or regions. When one sorts through these sources, one finds that there is in fact quite a lot of information available. The problem is that much of it is localized and partial, so it is hard to avoid getting lost in the detail. Based on my review of those data sources, which I do not claim is comprehensive, the following appear to be the most important characteristics of informal producers in Africa.

2.1. Extensive, widespread. Probably the most important

[3] In 28 of the 30 countries with relevant data, the percentage of secondary school age people enrolled in school is less than 40%. In 17 of these countries, the ratio is less than 20%. The comparable figure for Peru is 65%.

characteristic of informal producers in Africa is that there are a great many of them. Whenever people have taken the care to look in detail, they have found many more people engaged in such activities than either they or their governments had expected. Informal enterprises are not only unregulated; they are also unrecognized by the government. A recent survey in Zambia went from house to house in rural areas to collect detailed information concerning non-agricultural economic activities. The researchers estimated on the basis of their survey that less than 20% of the manufacturing employment in the country was in registered enterprises. Their estimate of the level of manufacturing employment was approximately double the number which the government had previously believed to be employed in these activities (i.e. about half the manufacturing employment was in enterprises which the government previously did not know about, and over which it exercised no control).[4] A similar survey in Sierra Leone yielded comparable results: government estimates of industrial employment shortly before the survey yielded an estimate which was only 56% of the estimate made on the basis of the survey.[5] A study of the structure of employment in Rwanda concluded that 91% of manufacturing employment, 60% of employment in commerce and 53% of total employment outside of family agriculture was in informal enterprises.[6] ILO surveys in a number of African cities have documented considerable amounts of economic activity in urban informal enterprises. In Abidjan, for example, 35% of manufacturing employment in 1970, 58% of employment in trade and commerce, and 31% of total urban employment was classified as taking place in informal enterprises.[7] Of the smaller numbers engaged in manufacturing

[4] John T. Milimo and Yacob Fisseha, Rural Small Scale Enterprises in Zambia: Results of a 1985 Country-wide Survey (Michigan State University Working Paper No. 28, 1986), pp. iii and 27.

[5] Carl Liedholm and Enyinna Chuta, The Economics of Rural and Urban Small-Scale Industries in Sierra Leone, African Rural Economy Paper No. 14 (Njala University College, Njala, Sierra Leone and Michigan State University, 1976), p. 8.

[6] Khiem Nguyen-Huu, Etude sur l'emploi au Rwanda: Situation actuelle, exploitation des données existantes, Ministère des Finances et de l'Economie, Etudes des mesures d'encouragement à l'investissement et à l'emploi, Document de Travail No. 6, Kigali, décembre 1987.

[7] H. Joshi, H. Lubell and J. Mouly, Abidjan: Urban Development and Employment in the Ivory Coast (Geneva: International Labour Office, 1976). The definition of informal sector in this study, as in all the ILO's work, is different from that of de Soto, being based on enterprise size, production characteristics and

employment in Kumasi, Ghana, it was estimated that two-thirds were in the informal sector.[8]

2.2. Mostly rural. While the ILO's work, which concentrated primarily in cities, has documented considerable informal activity in African urban locations, a more comprehensive view makes clear that the overwhelming majority of informal producers in most African countries operate in rural locations. In part, this is a reflection of the structure of the economies themselves, which as we have seen are largely rural. Even leaving aside traditional small-holder agriculture (most of which should probably be classified as informal, although that category is not included in the discussion of this paper), most observers are surprised at the extent of informal, non-agricultural activities in rural areas. Wherever it has been possible in Africa to take a comprehensive look at informal enterprises, it has been found that the great majority of such producers operate outside the major urban centers.[9]

2.3. Mostly small. Much of the analysis of this category of producers in Africa has been focused on small producers: the target population under study was restricted in one way or another by size. Obviously one cannot use such research to prove that all informal producers are small, since only small producers were studied. Yet there are three things which lend weight to the belief that the overwhelming majority of informal producers in Africa are small, indeed, very small.

entrepreneurial behavior. There is probably a considerable overlap between enterprises defined in these different ways, although this supposition is not based on any precise analysis.

[8] G. Aryee, "The Informal Manufacturing Sector in Kumasi," in S. V. Sethuraman, The Urban Informal Sector in Developing Countries: Employment, Poverty and Environment (Geneva: International Labor Office, 1981). ILO urban informal sector studies have been undertaken in Lagos, Lomé, Nairobi, Freetown, Dakar, Ouagadougou, the Gambia, Abidjan, Nouakchott, Bamako, Kigali, Lusaka, Kitwe, Mongu, and Yaoundé. See references in S. V. Sethuraman, op. cit.; ILO, Bibliography of Published Research of the World Employment Program (Geneva: ILO, 1984); and F. M. Painter, "The Informal Sector: Perspectives from the Literature" (USAID, Bureau for Private Enterprise, 1989). Most of the ILO studies examined the characteristics of a particular (non-random) sample of informal enterprises, making it impossible to provide estimates of the magnitude of informal activities relative either to the city as a whole or to the national economy.

[9] See, for example, the studies of Sierra Leone, Abidjan (the Ivory Coast) and Rwanda cited above.

i) For several such studies, the definition used of "small" was enterprises with up to 50 workers, a fairly high cut-off point. Among the enterprises near the upper end of that boundary, virtually all were fairly deeply enmeshed in the formal sector: they were registered and licensed, they paid taxes, they found they had to obey masses of government regulations. This is quite different from the enterprises at the opposite end of the size spectrum, who almost universally had none of those characteristics.

ii) Some of the studies cited (e.g. the ones in Rwanda) were not restricted to small producers. Among the medium and larger enterprises, virtually none were outside the government's legal and regulatory net (although of course this does not imply that they perfectly fulfilled all the requirements of the law!).

iii) African economies themselves being small, it is hard for medium or larger sized enterprises to hide from the watchful eye of the regulators.

Informal is not the same as small. The defining characteristics are different. But empirical studies make clear that, at least in Africa, there is a very large overlap between the two enterprise groups. Studies done of small or micro-enterprises have much to contribute to an understanding of the characteristics of informal producers, since to a large extent they are the same producers, seen through a different set of glasses.

2.4. The breakdown of informal activities by economic sector suggests the overwhelming predominance of two major categories: commerce and manufacturing. Less informal production has been reported in Africa in construction or transport. One must be aware of the danger that what one observes is primarily a reflection of what one was looking for rather than of what is actually there. With that caveat, the data suggest that in rural areas the most prevalent informal activities are in manufacturing. As one moves to larger urban agglomerations, the balance shifts towards trading.

2.5. Growth patterns and growth potential: what should we be hoping for, in terms of patterns of growth for different types of enterprises, particularly those in the informal sector? This question can be approached at three different levels: in terms of the overall enterprise structure in the economy, in terms of particular subsectors, and in terms of individual producing units.

i) Overall enterprise structure and its transformation: two decades of cross-country research have made clear that

development means change in the structure of the economy.[10] Some sectors (e.g. metal products, paper and paper products) grow dramatically in importance, while others (most importantly, agriculture) account for a declining share of GDP. An important component of development, then, involves a process through which people move out of slowly-growing product lines to others where productivity is higher and demand is increasing. Policies towards the informal sector need to be careful to avoid providing subsidies which retard movement out of activities from which participants should be leaving.

Another dimension of this structural transformation, less thoroughly documented but currently under study, concerns the evolution over time of the size structure of enterprises. Anderson and others have hypothesized that, as economies grow richer, there is a shift out of household and artisanal activities first to small workshops and factories, then into large factories.[11] In the early phases, when household and artisanal enterprises predominate, Anderson emphasizes the heterogeneity of experience by country, by location (urban vs. rural) and by industry group for informal producers. While recognizing both the predominance of household manufacturing (i.e. informal producers) over long periods as well as their gradual replacement by larger enterprises and more formal modes of production, he also documents the dynamic diversity that exists even during this early phase, which he describes as being characteristic of most African countries today.

ii) Subsector dimensions: informal producers interact in a variety of ways with other enterprises, whether formal or informal. A large, modern enterprise sells kiln-dried lumber to large numbers of small, informal carpenters, thereby enabling the latter to improve the quality of their products. Alternatively, a formally recognized commercial enterprise can handle the marketing function for a variety of informal producers, enabling them to specialize by concentrating their efforts on production activities.

[10] See, in particular, the work of Hollis Chenery and his associates. The most recent reporting of this body of research is in Moshe Syrquin, "Patterns of Structural Change," in H. Chenery and T. N. Srinivasan, Handbook of Development Economics, Vol. I (Elsevier Science Publishers, 1988).

[11] Dennis Anderson, Small Industry in Developing Countries: Some Issues, World Bank Staff Working Papers No. 518, 1982. See also Tyler Biggs and Jeremy Oppenheim, "What Drives the Size Distribution of Firms in Developing Countries?" Employment and Enterprise Policy Analysis Discussion Paper No. 6, Harvard Institute for International Development, November, 1986.

In other situations, the subsector relationships are competitive: small tailors compete with large ready-made garment manufacturers, traditional brick makers compete with capital-intensive modern factories. In general, an understanding of the position of informal producers is impossible unless one understands these producers' links backwards to suppliers and forwards to markets, and the competition which they face from others supplying the same product or service. Informal producers operate in ways which are embedded in subsectors, and cannot be understood in isolation from those subsectors.

iii) Individual producers: an accent on diversity. Those who have studied or worked with informal sector producers are deeply aware of the heterogeneity of these enterprises.

a) Some are operating in activities which should be considered as dead-end traps. These product lines often involve low barriers to entry, in terms of required production and management skills as well as of capital. The enterprises are characterized by low levels of economic efficiency and generally provide only very low levels of income for those who are engaged. People move into these lines because they cannot find anything better to do. Their expansion is a sign of the failure of the rest of the economy to grow fast enough to absorb those looking for work.

b) Other informal sector producers are in a considerably stronger position. Economic efficiency is high, returns to those involved in the production process are rewarding. These enterprises seem to have considerable growth potential; for them, a central question concerns the nature of the constraints which they face: what needs to be done to help them grow? The search for policy changes or project interventions needs to focus on ways of helping bring this about.

iv) Graduation issues. As suggested in previous paragraphs, one of the principal issues with regard to informal enterprises concerns questions of their growth potential. There is a diversity of opinion concerning the extent to which such producers serve as a seedbed from which modern, larger enterprises emerge. A recent study explores the extent to which this has happened in Africa and elsewhere. The approach used involves looking at modern, formal sector medium-size producers to determine how many of them started as very small (presumably informal) enterprises, growing through the ranks rather than being established from the start as medium or larger-size, formal enterprises. The results, currently available for only seven countries, provide interesting insights. They indicate that the share of modern firms which started out as very small, then graduated, is consistently lower in Africa than in the other countries studied; furthermore, it is lower in Central and

Southern Africa than in West Africa.[12] Two possible explanations have been advanced for the lower graduation rates in Africa. One concerns issues of entrepreneurial skills among informal sector producers, and particularly their limited ability to deal with the more complex management functions of larger enterprises.[13] A second concerns an unfavorable policy environment, inhibiting this process of growth of informal enterprises. Such policy-induced hindrances are discussed in the following section of this paper.

III. Policy implications. As we have seen, the economies in which African informal producers operate are mostly small, fragmented and growing only slowly. In most, the expansion of employment in the modern sector has not kept pace with the rapidly growing labor force; there is considerable pressure to seek work in a variety of activities which are unrecognized and unregulated by the government, i.e. in informal enterprises. Some of these seem to offer few possibilities for growth; others, on the other hand, reflect efficient resource use, satisfactory and growing income levels for those who participate, and the potential for growth and "graduation" to larger and more modern enterprises.

In this situation, the primary policy goals for informal producers, as for the economy as a whole, are two:

i) establish an overall policy framework in which the economy itself grows, thereby creating expanding employment opportunities in productive enterprises as well as growing markets in which dynamic enterprises are able to sell; and

ii) strengthen the ability of productive enterprises to respond to this growing demand.

The principal components of such an approach are as follows.

[12] C. Liedholm and J. Parker, "Small Scale Manufacturing Growth in Africa: Initial Evidence," MSU International Development Working Paper No. 33 (East Lansing: Michigan State University Department of Agricultural Economics, 1989). The reported percentages of modern enterprises which started from "micro" origins and subsequently "graduated" were as follows: Rwanda, 11%; Botswana, 20%; Sierra Leone, 30%; Nigeria, 44%; Philippines, 49%; Colombia, 50%; and India, 66%. Research is continuing on this topic, among other things, to add other countries to the sample.

[13] This point of view has been forcefully argued in P. Kilby, "Breaking the Entrepreneurial Bottleneck in Late-Developing Countries: Is there a Useful Role for Government?" Draft paper, Wesleyan University, March 1988.

3.1. One must start by underlining the central importance of agriculture. That sector is the major source of income for the rural majority. Our reasoning suggests that the major constraint facing non-agricultural producers, formal as well as informal, is the low level of domestic demand; the most likely way of resolving that constraint is through an expansion in agricultural output and income. In the absence of growth in agriculture, it is hard to see how any other change can have more than a marginal impact.

Examples can be given of successful policy change in African agriculture. The first comes from Mali, and involves "a process of removing legal prohibitions to private trade in selected commodities and taking other actions aimed at facilitating the functioning of the private sector, with the objective of placing greater reliance on the market to allocate resources."[14] This process has been gradual and hesitant; it was started in 1981 and is still under way. A recent review of that process concluded that, while the changes have achieved encouraging results, they could "hardly be called a complete success. Despite the progressive liberalization of domestic trade and imports of cereals, many aspects of the private trade still remain heavily regulated...similarly, although farmers have benefitted from the liberalization, their capacity to respond to the new opportunities has been severely limited by restricted access to improved technologies, input supplies, and supporting institutions...Liberalization involves fundamental reallocation of roles between the public and private sectors. If liberalization is to lead to improved market performance, it is not enough that the state stop doing certain things, like running monopoly marketing systems. The state must also take on new responsibilities, such as providing public information systems and improving credit markets, in order to facilitate the private trade's ability to respond to its new opportunities."[15]

Mali is not alone in its liberalization efforts with regard to agricultural production and trade. While it may be too early to judge its effects in detail, the market reform process in Tanzania appears to be leading the country rapidly away from its heavy dependence on regulations towards an approach which relies

[14] John M. Staatz, Josué Dioné and N. Nango Dembélé, "Cereals Market Liberalization in Mali," forthcoming in World Development.

[15] Ibid, pp. 27-29.

more on market forces.[16] The World Bank\UNDP study previously cited suggests that 14 countries in Africa are currently engaged in "strong reform programs" dealing with agriculture. As indicated above, that study provides an optimistic assessment of the impact of these reforms on agricultural output in Africa over the past four years.

3.2. A second category of policies relates not to a particular sector of the economy but to a group of policy instruments falling on a country's foreign trade: exchange rates, tariffs, licenses and policies to promote exports. These are important for at least four reasons:

i) African countries, and particularly low-income African countries, rely to a relatively high degree on foreign trade.[17] Trade policies are important, then, because trade itself is important for these countries.

ii) Expanding exports constitute a key way of overcoming the problem of very small national markets. Some have argued that if small countries focus primarily on the development of domestic markets, giving only secondary attention to their participation in world trade, they will inevitably remain poor.

iii) Protection means special favors for formal sector producers, who are thereby placed at an advantage relative to small and informal enterprises. A protected, large-scale factory producing corrugated sheets can buy imported inputs (which comprise a major portion of the firm's costs) on artificially favorable terms as a result of an overvalued exchange rate; a small rural producer of roofing tiles might then find it impossible to compete, although from a national welfare point of

[16] See H. K. R. Amani, S. M. Kapunda, N. H. I. Lipumba and B. J. Ndulu, "Effects of Market Liberalization on Food Security in Tanzania," in M. Rukuni and R. H. Bersten, eds. Southern Africa: Food Security Policy Options (Harare: UZ/MSU Food Security Research in Southern Africa Project, 1987).

[17] The ratio of merchandise trade to GDP for the low-income countries of Africa and Asia and the comparable figures for Peru are as follows:

	Merchandise exports/GDP	Merchandise imports/GDP
Low-income Africa	0.15	0.21
Low-income Asia	0.09	0.13
Peru	0.10	0.11

view his production is preferable.[18]

iv) In most countries of Africa, trade policy constitutes the single most important domain of government intervention, where market forces are most widely replaced by administrative decision-making. This administrative orientation imposes major costs throughout the economy but particularly on informal enterprises who find that the availability of competing imported finished goods as well as imported inputs is determined through discretionary decisions of government officials who may not even recognize the existence of such enterprises.

The design and orientation of a country's foreign trade policy is probably the most controversial area which policy-makers must address. Positions are taken on the basis of complex and deeply-held views relating to national sovereignty and independence, the power and role of different groups in the economy, and the capacity of domestic suppliers to respond to new incentives and opportunities. While a number of changes can be documented in individual tariff rates, particular licensing procedures or export incentive schemes, fundamental changes in orientation to move radically from administrative systems towards increased reliance on market forces are rarer and more traumatic, often undertaken under dire circumstances and heavy external pressures. Some of these have proven disastrous for the country (Zambia in 1986, Ghana in 1971). For many recent moves in this direction, too little time has passed to permit a valid appraisal as to how far-ranging and successful the reforms have been.

In general, African bureaucrats remain profoundly skeptical about the ability of such trade liberalization and market reforms to revitalize stagnant or slowly-growing economies. The Mali experience discussed above suggests that fundamental changes require not only dismantling some controls and regulations but also undertaking a variety of new initiatives which will make it possible for private producers to take advantage of the new opportunities being created. In general, the process will be a gradual and lengthy one. Significant changes can be and have been made in the meantime in the management of existing systems (e. g. improved administrative procedures for issuing import licenses or for clearing goods through customs). As long, though, as the macroeconomic context is one of substantial excess

[18] This case is explored for Rwanda in Nguyen-Huu Khiem, "Etude sous-sectorielle: le secteur de construction au Rwanda," Ministère des Finances et de l'Economie, Etudes des mesures d'encouragement à l'investissement et à l'emploi, Document de Travail No. 8, juin, 1988; and A. Ngirabatware, L. Murembya and D. Mead, "Medium and Large Private Manufacturing Firms in Rwanda: Diagnostic Study of Current Situation and Policy Impact," Working Paper No. 9, August, 1988.

demand for foreign exchange kept under control by a process of administrative allocations, there are clear limits to the amount that can be achieved through such procedural improvements.

3.3. Credit: if one asks informal producers about their principal needs, they almost invariably start with credit. This response, though, cannot be taken at face value. Many respondents see credit--especially credit made possible through foreign aid programs--as a subsidy, as a scarcely-veiled cash transfer. Many projects for which credit is requested by small and informal enterprises are not financially viable, in the sense of generating enough additional revenue to make it possible to repay the loan. For most African small and informal enterprises, it is not lack of credit which is the binding constraint holding them back from innovation or productive new investments. Rather it is the small and slowly-growing markets in which they sell, their limited information about new products which they might introduce, about new markets which they might seek to enter or about technologies and management skills which would enable them to produce these products at competitive costs. Legal and administrative hurdles also raise production costs and increase risks, thereby discouraging innovation. Without changes in these complementary dimensions, efforts to achieve an expanded flow of credit to small or informal producers have generally had only a limited impact.

Two types of policy interventions have been tried in this area, neither with much success. The first has involved subsidized credit, offering loans to informal borrowers at below-market interest rates. The limitations of such an approach have been documented a number of times[19]; they include the strong negative effects of such programs on the financial viability of the lending institution, and the need to replace market forces by administrative decision-making in the allocation of the inevitably limited amount of funds which can be made available in this way. An alternative approach which avoids some of these objections would involve a subsidy to cover some of the additional costs associated with the processing of loans to small borrowers. This approach would avoid the necessity of charging very high interest rates to handle the additional administrative costs usually associated with such loans, but would otherwise leave the allocation of loan funds to market forces. Of course such interventions do not change the fundamental idea, expressed above, that making credit more easily available, or available at a lower interest rate, will be ineffective in promoting the

[19] See, for example, Dale Adams, Douglas Graham and J. D. Von Pischke, Undermining Rural Development with Cheap Credit (Boulder: The Westview Press, 1984); and J. D. Von Pischke, D. Adams and G. Donald, Rural Financial Markets in Developing Countries (Baltimore: The Johns Hopkins University Press, 1983).

growth of informal enterprises unless it is accompanied by other changes which raise the productivity of investments by such enterprises.

A second type of policy intervention in the credit area is aimed at the collateral problem: many small or informal enterprises do not have assets which could serve as collateral for loans. A frequently-tried response to this problem is to establish credit guarantee funds to which financial institutions can turn in cases of viable projects presented by borrowers with inadequate collateral.[20] While such loan guarantee funds are widespread in Africa, they have had only a marginal impact on the flow of credit to small or informal borrowers, suggesting once again that the limiting constraint on credit expansion is not collateral as much as viable projects.

The high transactions costs in the processing of loans for small or informal enterprises has already been alluded to above. Standard lending procedures by financial institutions for loans to small borrowers involve loan processing costs which can be a high percentage of the value of the loan, making it difficult if not impossible for financial institutions to make such loans at other than very high interest rates. There are alternative approaches which permit the reduction of these transactions costs in small credit programs; the key features here involve character-based lending, with repeating loans based originally on small and short-term credit, often in the context of some joint responsibility for repayment among groups of borrowers.[21] Efforts are currently under way to introduce such simplified lending procedures in a number of African countries.

3.4. Taxes: enterprises which are not registered or recognized by the government (i.e. informal producers) generally escape a number of different types of taxes, including profits taxes. Of course this does not mean they avoid all taxes; they would generally be subject to any existing sales taxes on purchased inputs as well as duties on imported inputs. The latter can be important; formal enterprises can often obtain

[20] As we shall see below, an alternative approach here involves improving the legal framework so that more clearly established rights of ownership of assets permit their use by borrowers as backing for loans.

[21] For an elaboration of these ideas, see Carl Liedholm, "Small Scale Enterprise Credit Schemes: Administrative Costs and the Role of Inventory Norms," MSU International Development Working Paper No. 25, 1985. One might notice that the high transactions costs associated with standard lending procedures in this case arise not from bureaucratic regulations but because of factors inherent in lending to small borrowers using traditional bankers' criteria.

exemptions from tariffs on imported inputs, while this facility is never available to unregistered enterprises. In general, though, studies make clear that informal enterprises pay relatively low taxes compared to their formal sector counterparts.[22] Problems arise when they seek to grow, to innovate. The more successful they are in this regard, the more difficult it is for them to continue to avoid the tax man. The tax structure thus constitutes a significant disincentive to innovation and development.

Some countries have sought to deal with this problem by extending the availability of tax holidays to make these accessible to small informal enterprises on the point of entering the formal sector. There are several problems with this supposed solution. Firms must first go through all the procedures of formalization, which can be time-consuming and uncertain in its outcome; then they apply for tax exemptions under provisions of the investment code, again a lengthy and uncertain process. In general, it would be far preferable to deal with this problem by establishing a simple but comprehensive value added tax or, if that is felt to be unworkable, a system of universal taxation of all producers at low enough levels to avoid a high marginal rate on entering the system.

A number of African countries have introduced modifications in their tax laws and procedures, based on an improved understanding of the ways in which the laws operate in practice to affect producers of different types and sizes. This enhanced understanding has resulted from information coming from a variety of sources: from special studies of the tax system, from public meetings in which business people are invited to air their views, and through the efforts of organizations and agencies working directly with producers. The latter group, often NGO's and PVO's, frequently work closely with enterprises of different types and sizes and so are in a good position to understand their problems. On the basis of this understanding, these organizations have sometimes been effective in working with governments to bring about improvements in tax laws as well as in

[22] Dr. de Soto's analysis reminds us that, in addition to indirect taxes, informal producers can be particularly hurt ("taxed") by inflation, if shortage of working capital prevents them from stockpiling raw materials. They may also be caught if they sell inputs to someone who pays a value added tax. To date, value added taxes are virtually unknown in Africa; for the time being, fortunately, inflation rates in Africa have not approached the triple or quadruple-digit levels of Latin America.

other areas of policy.[23] This is a fruitful approach which deserves to be encouraged where possible.

3.5. Education and training. It has been suggested above that one of the major constraints on enterprise growth among informal as well as formal producers concerns the limited capacity of entrepreneurs to respond to the demand which exists in the markets where they sell. While the relationship between education and entrepreneurial ability is not clear, it seems plausible to argue that the widespread low levels of literacy in Africa constitute a serious handicap to enterprise growth and development, both in terms of management abilities and in production skills for more complex products. Essentially this implies a plea for increased spending on secondary education, and a greater orientation of all education towards entrepreneurial skills rather than simply feeding the bureaucracy. It is also a plea for reorienting the country's vocational training programs. In the past, these have not infrequently had the effect of providing a limited range of basic skills to far more people than the economy can absorb.

3.6. Administrative regulations and procedures: every knowledgeable observer agrees that administrative procedures and regulations are a significant hindrance to enterprise growth and development in Africa. There is a widespread mistrust of markets and market forces by intellectuals and civil servants alike, leading to a widespread presumption of the need for administrators to intervene at every step of the way. The famous 289 days which it takes to establish a business in Lima would be equally true in most African countries. The Chamber of Commerce in Rwanda did a similar study in 1988 and found even more lengthy procedures--and the figures were then criticized by the business community as understating the problem.

The detailed focus of these regulatory problems seems to vary from country to country. Some have argued that the problem is more serious--or at least different in nature--in former French colonies, compared to the former British colonies.[24] Prime offenders about which one hears complaints throughout the continent include:

-registration and licensing of new enterprises;

[23] See, for example, Thomas Dichter, "Demystifying 'Policy Dialogue:' How Private Voluntary Organizations Can Have an Impact on Host Country Policies" (Norwalk: Technoserve Replication and Dissemination Publications, 1986).

[24] See, for example, the discussion of John Page, in his Small Enterprises in African Development: A Survey, World Bank Staff Working Paper No. 363 (October, 1979), p. 37.

-product quality controls, often designed to prevent lower-quality--but also lower cost--products from entering the market, thereby discriminating against informal producers as well as low-income consumers;

-health and sanitary regulations, often criticized as being in fact based on aesthetics;

-labor regulations, relating to hiring, firing, and working conditions.

Many of these regulations are the obverse side of a weak and imprecise legal system: in the absence of clearly defined laws, administrators must provide regulations and interpretations which surpass the laws themselves in their volume and often in their complexity.

These administrative regulations are painful for all, formal and informal producers alike. While informal enterprises are by definition outside the government's laws, they are affected by most of the regulations mentioned above. Yet one should not ignore the fact that these regulations fall in a particularly savage way on formal producers as well; in fact, formal sector firms may be more severely hit by them than the informal enterprises, since the latter find ways of escaping some of the provisions by virtue of their informality. The experience of Burkina Faso (in 1985) and of Rwanda (in 1988) suggests that, just as Mr. de Soto has sought to mobilize informal producers as a pressure group to bring about change, so an aroused group of formal producers, in both cases operating through the national Chamber of Commerce, can raise an outcry which can be effective in helping press for the removal of some of the most serious problems in the regulatory environment.

3.7. Legal system: Policy-makers, scholars and development practitioners alike have come to recognize the central importance of the legal system in providing a context in which business people find it worth their while to innovate. If entrepreneurs are to be willing to undertake the risks which inevitably accompany that process, there must be a reliable system which will assure them that the fruits of their labors will belong to them. In general, in Africa, such a system does not exist. The legal system is often based on antiquated colonial laws, overlaid with vast amounts of administrative interpretation. Settling any kind of dispute through the courts is often a slow and uncertain process. Business people rely on personal contacts with bureaucrats more than they do on the courts to obtain particular rights and to ensure that these rights are protected. This means that such rights are only as reliable as the person who grants and interprets them, a person who may be out of office in the next government change or who may change his mind in the

meantime.

Issues of property rights concerning land are particularly important. The process of obtaining secure tenure on the land has regularly been identified as an obstacle to development all over Africa. There is an urgent need for secure land rights to enable people to build, to improve, to use land as collateral, perhaps to buy and sell it. The fact is, though, that the establishment of these rights is an extraordinarily complex and often expensive process. In many African countries, the land traditionally belongs either to the state or to the community; deeply-held traditions have to be taken into account and perhaps modified if individual rights are to be firmly established. Cadastral surveys generally are expensive, involve extensive administrative capacity as well as the resolution of complex legal issues to determine who has the right to what, particularly in cases of multiple uses (e.g. for grazing). Where the land is already occupied, some level of government (preferably, one as close as possible to the people) will inevitably need to play a central role in adjudicating between different claimants. In that process, some will benefit, others will be harmed. One cannot simply leave these matters to the forces of the market, unless one believes either in the sainthood of the populace or the law of the jungle.

Not all property rights relate to land. Whatever is "my own," I can do with as I like (within limits prescribed by the law), including preventing others from trespassing on my property. But when is someone trespassing? How far do my rights to exclusion go? In particular, when I receive a license to produce something, that is a form of property right which is granted to me, which may imply a willingness to prevent others from "trespassing on my property" by producing the same thing. The same issue arises whether the producer involved is formal or informal.[25] This form of protection of property rights has been extensively abused in Africa, sanctioning the establishment of monopolies or closed oligopolies in many products in many countries. Yet one must recognize the complexity of the questions at issue here. Where markets are small and fragmented, there are important externalities linking the actions of one producer with those of another. Economies of scale can lead to natural monopolies, even in the absence of government intervention. Where foreigners or ethnic minorities have easier

[25] De Soto reports that informal transport operators found the need early on to organize; one of the goals of their organization was to keep out new competition, once there was sufficient capacity to meet the demand (The Other Path, p. 99). It is not obvious that informals, organizing among themselves, would be less self-serving in this regard and more interested in the public welfare than government officials.

access to information or other special advantages, they may be the principal ones to establish themselves in pre-eminent positions in such markets. A decision by the government to limit its involvement to establishing the rules, then standing on the sidelines to watch the game go forward, may bring results which are unacceptable from the point of view of static economic efficiency, of dynamic economic growth, and of political realism. This is not to deny that regulations and administrative interventions in such cases have frequently been so extensive as to wrap the aspiring entrepreneur in a blanket of cobwebs and glue; it constitutes rather a reminder that what is needed is a rethinking and reformulation of those regulations, not simply their elimination.

A second set of legal issues concerns contracts. In early stages of development, transactions are generally restricted to exchanges with partners whom one knows and can trust because of family ties or other personal relationships, or with those who are subject to some kind of moral pressures, perhaps exercised through a common ethnic group. As the economy grows more complex, the absence of reliable contracts makes it impossible for producers to reach beyond this restricted group of partners to buy from or sell to anyone who offers the best terms.[26]

It is revealing in this context to consider the question of subcontracting. This type of business arrangement has been widely used in parts of Asia, enabling enterprises to specialize either in a particular step in the production process or in production, as opposed to marketing.[27] By contrast, such contract arrangements are rarely used in Africa. One possible explanation concerns the weak and ineffective system of contract law in force on the continent. If a supplier fails to fulfill his promise to provide a certain product, the buyer has recourse to only limited forms of sanctions; conversely, if a buyer

[26] The role of the legal system in the development of reliable contracts and improved contract compliance is not obvious. For serious business people, the threat of being taken to court for non-compliance may not be as serious as the risk that word will get around, and as a result it will be difficult to get more contracts. In such a situation, an improved exchange of information about who performs well may be as important to the expansion of the network of commercial transactions as an improved legal system.

[27] See Donald Mead, "Subcontracting Systems in Bangladesh," a report for the Dhaka USAID Mission (July, 1985), which documents extensive subcontracting in that country, often involving small (informal) producers. See also, by the same author, "Subcontracting Systems and Assistance Programs: Opportunities for Intervention," MSU International Development Working Paper No. 24, 1985.

decides not to honor an order he has placed, the seller is left with unsaleable production. The increase in risks on both sides resulting from a weak system of contract law may be an important part of the reason why this potentially fruitful pattern of specialization has not taken root in Africa.[28]

There has been considerable movement in the area of legal reform in Sub-Saharan Africa. Many changes have been legislated, particularly in the area of property rights for land. In fact, the changes in the legal code seem frequently to have outpaced the ability of the administrative system to implement these changes; the gap between de facto and de jure procedures may be widening. While the situation varies from country to country, in a number of cases, problems of implementation seem to be as important as the content of the laws themselves.[29]

IV. Summary. The principal conclusions from the preceding analysis can be briefly stated. There are two major ways in which the situation in Africa resembles the one described for Lima by Mr. de Soto and his colleagues:

i) There are large numbers of people engaged in activities which are neither recognized nor regulated by the government. These enterprises have a variety of characteristics which appear to make them different from those in Lima: their rural preponderance, their small size, the nature of the growth constraints which they face, etc.; but it is clear that, in Africa as in Lima, such activities, which may be called informal, are very widespread.

ii) African economies are widely characterized by weak legal systems and cumbersome administrative and regulatory environments. These characteristics have received inadequate attention to date in the analysis of the development process and

[28] Much of the subcontracting in Asia has involved larger, formal enterprises contracting with smaller, sometimes informal suppliers to undertake a particular step in the production process. The interest on the part of "parent" firms to adopt this procedure often comes from the fact that it is less costly, and these parent firms are under strong competitive pressures to minimize costs. The fact that many of the potential parents in Africa operate in protected markets reduces their incentives to search for such cost-reducing arrangements.

[29] For a good review of issues of property rights as they relate to land, see John W. Bruce, "Land Tenure Reform and Agricultural Development in Africa: A Review of Recent Experience," The Land Tenure Center, University of Wisconsin-Madison (Mimeographed), April, 1987.

of policy reform; they impose serious constraints on dynamic and innovative enterprises. The goals of simplification, decentralization and deregulation seem as appropriate and as urgent for Africa as they are for Peru. At the same time, it should be recognized that if private entrepreneurs of all types are to take advantage of the new opportunities opened up to them by a process of legal and administrative reform, additional steps may be needed to ensure that these enterprises have access to information, to credit and to requisite skills.

Mr. de Soto has described four sets of factors which, according to his research, link these two characteristics of an extensive informal sector and an inadequate legal and administrative system. These linkages appear to be quite different in Africa; in fact, they appear to be much weaker, if they exist at all.

i) In Africa, the cumbersome system of laws and regulations constitutes only one among many dimensions of the explanation for the origins of these unrecognized and unregulated enterprises. Particularly for the majority of such producers who are located in rural areas, the regulations are not the most important part of this explanation. People search for alternative sources of income starting where they are, from among the alternatives which they know. The fact that most of these alternatives are not controlled or regulated by the government is often incidental to the process of growth of such activities.

ii) The system of laws and regulations comprises only one among many problems facing producers seeking to innovate, to grow and to modernize. These laws and regulations are often a more serious problem for formal than for informal enterprises. For most informal producers, the legal and administrative environment does not seem to be the most serious constraint hindering their growth; rather that comes from the very small markets in which they sell, and their limited capacity to respond effectively to the demand which does exist.[30]

iii) No research has been done in Africa which would suggest that informal operating agreements among informal producers could serve as a model for revising the formal laws and regulations, as has been suggested as being the case in Lima.

iv) There is no reason to believe that informal producers in Africa are likely to be a more effective pressure group than other participants in the on-going policy dialogue. Most African

[30] Of course the unfavorable legal and administrative environment is part of the explanation for both the small and fragmented markets and for the limited capacity of producers to respond to those markets; but that environment does not seem to be the principal explanation for either aspect.

officials who make and administer policy are truly interested in the development of their country; they are no more venal, malevolent or power-hungry than the rest of us. They make decisions on the basis of the information which is available to them and of their understanding of how the economy operates. There have been a number of changes in policy in Africa which have resulted from an improved flow of information to policy-makers. Many sources have contributed to that flow: academic research, the practical field experience of PVO's and NGO's, and the voices of entrepreneurs from both informal and formal enterprises, expressed in a variety of fora. While it is highly desirable to add the voices of informal producers to these discussion since they have important information to contribute, it is unrealistic to think that such producers can be mobilized in most countries in Africa in such a manner as to transform the discussion in a fundamental way.