FINANCIAL SUPPORT PROGRAMMES FOR THE INFORMAL SECTOR: SOME LESSONS FROM EXPERIENCES

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1. INTRODUCTION

The informal sector is being increasingly recognized as a separate economic sector, with its own characteristics and potential to contribute to economic and social development, and to create jobs in particular. The slow-down of economic growth in the Third World during the 1980s has stimulated renewed interest in the role of the informal sector as an instrument for employment creation and poverty alleviation.

Since the early 1970s informal sector support programmes have mushroomed in Latin America as well as in Africa and Asia, encouraged by the injections of financial assistance from bilateral and multilateral donor agencies. The main instrument of intervention has been credit, for it is generally believed that lack of access to finance is the most pressing of all problems of the sector.

There is a large body of literature providing for alternative models of extending financial assistance to the sector. Some lessons for what is likely to work and what does not are beginning to emerge. Given the phenomenal potential of the sector in Ethiopia, any more indifference would be an unaffordable luxury. It is widely recognized that there is a need to draw up policies and strategies for the development and promotion of the sector, and to provide adequate support systems as well as an appropriate legal and institutional framework.

This endeavour would require adequate and reliable information. In this regard, the experiences of other countries can provide a great deal of scope for transfer of learning as a basis for innovative approaches for the development of the sector. To this effect, this paper is an attempt to provide an overall overview of some of the financial assistance programmes that have been implemented since the early 1970s. This paper is by no means a comprehensive analysis of the issue at hand.

The paper is arranged as follows. A brief summary of the salient features of the informal sector, the policy issues and overall support measures are discussed first as a background, and this is followed by a review of relevant international experiences on the various financial assistance schemes. Based on the experiences of countries, possible lessons are drawn in the third part. Finally, concluding remarks are forwarded.

definition, however, it is impossible to be clear about what the problem is, or what to do about it.

1.2 Informality: causes, problems and prospects

The main reasons for the expansion of the sector around the world are, inter alia, stagnating wage employment opportunities, corrupt bureaucratic procedures, and internal migration. The slow growth of the formal economy, with its failure to create adequate employment, is believed to be the main cause for the informality in the developing world. Mainly an urban phenomenon, the sector is claimed to gather a large number of the poor in developing countries.

Because of their unique economic and organizational characteristics, informal sector enterprises are well placed to have important economic, social and political roles in employment creation, resource utilization, and income generation. Generally, three main reasons can be pointed out for paying attention to the informal sector especially in developing countries (Chickering and Salahdin, 1991):

- the majority of the population are poor and most of them are in this sector;

- the formal sector is structurally incapable of absorbing the existing large number of unemployed and underemployed; and,

- the informal sector is a reserve of productivity, creativity, initiative, and earning power, and it provides opportunities for self-employment, and thereby empowerment, for the poor.

The most perceived attraction of the sector in developing countries has therefore been that it has a large capacity for labour absorbtion. In the words of P.F. Drucker :

> in the developing world the first priority will be to create jobs for the large masses of young people. This will have to take precedence over nationalist pride and traditional beliefs...It is a matter of survival -and survival has no priority (Drucker,1981).

The paradox is that the participants lose their full rights as citizens by operating outside the legal economy. The sector is said to be constrained by a host of internal and external factors the most important of which are illiteracy among the businessmen, lack of access to adequate output and input markets, to technology and credit facilities.

Most of the concerned people in the area of the informal sector development regard credit problems as the prime, if not the sole, obstacle to the promotion of the sector, and to the

Some Newly Industralized Countries(NICs) such as Singapore, Hong Kong and the Republic of Korea question the value of providing special government assistance for the sector. These countries have been observed to stress the need to create an overall economic environment conducive to enterprise and efficiency through appropriate macroeconomic policies.

Although there is much evidence to support the contention that policies biased in favour of large enterprises are ineffective, some countries have been successful in implementing some selective policy biases against small enterprises and the informal sector. Research on Taiwan and South Korea supports this (Robert, 1992).

In some countries, however, overall policies have proved to be inappropriate. The experience of Bangladesh suggests that an interventionist government policy is not always necessary for a flourishing informal sector unless it is carefully designed and comprehensive (Robert, 1992).

The weight of evidence is in support of the fact that traditional macroeconomic measures, which may suit the needs of the organized sector, are of little or no use to the informal sector as long as they do not take its particular problems into account, and are indeed detrimental to certain segments of the informal sector which might otherwise survive (Neck and Nelson, 1987; Harold Lubell, 1991; Malcolm Harper, 1992). Moreover, the often observed lack of determined state action on the part of the government to see the policies through has exasperated the problem.

The structural adjustment programmes of the 1980s modified or cancelled a number of the special advantages received by the formal sector as quantitative restrictions were removed, tariffs were lowered, currencies were devalued, and in some cases, interest rates were raised. In many instances, the changes affected the informal sector producers favourably in spite of (or because of) the difficulties faced by the formal sector as a result of the programmes (Harold Lubell, 1991; Robert, 1992).

Hence, the policy climate for the informal sector of the 1990s is more favourable than in the past as a consequence both of the wave of the World Bank-fostered Structural Adjustment Programmes(SAPs) of the 1980s and of the increased interest in the informal sector on the part of the international agencies and national governments. Although implicit discrimination against small and micro-enterprises is being markedly reduced as a result of the policy shifts noted, the whole issue of getting governments to take a positive attitude toward the informal sector is still a major challenge.

Very recently, therefore, some people began to be skeptical about overall policy measures and to propound independent actions which would require special programmes exclusively aimed at the informal sector. And this brought into the scene direct financial and non-financial assistance programmes to promote the sector which can be provided by institutions, associations, agencies, corporations, companies, firms and practitioners, distributors and individuals. They may deal with any or all of such functions as training schemes, management and extension services, The involvement in the programmes of other bodies such as NGOs is, therefore, imperative. Non-Government organizations (NGOs) have been quite active in both industrialized and developing countries, although in the later case there is far more involvement in the areas of financial and managerial or technical assistance to small and informal enterprises. The use of international NGOs is crucially important in (Less Developed Countries(LDCs) with deficient or distorted policies towards these enterprises. Another reason for the involvement of NGOs in the promotion of informal enterprises is the extent and the capacity to which governments are able to deliver the necessary services to the clients at the local level.

Besides, in most cases, the operations of NGOs was observed to make ideal partners for organizing communities at the grassroots level and for carrying out group-based programmes, including the setting up of revolving loan funds and short term courses on skill up-grading.

It was also realized that some attempts by governments to provide financial assistance to small enterprises have had limited success (Neck and Nelson, 1987). It is true that LDCs have the greatest need for government involvement, yet these are the very governments which can least afford the cost of enterprise promotion.

The controversial issue here is one of whether NGOs work together with the government. NGOs sometimes view the government as being too bureaucratic and rigid, and governments being always suspicious of NGOs. Where procedures to accomplish goals and objectives are in conflict, it may be impossible for governments and NGOs to develop a working relationship. While the goals of NGOs may be enterprise-specific, governments may view the enterprises within a wider range of goals. The extent to which governments co-ordinate and support NGOs activities will depend in part on political necessity.

Therefore, it is up to the NGO, the government and the proposed beneficiaries to agree on specific programmes to be offered by the NGO. But the appropriate role of the government in promoting the activities of NGOs in LDCs has yet to be defined. One thing is, however, for sure: whatever assistance is provided by NGOs to informal enterprises will relieve the government of providing such assistance.

Any support measure for the informal sector should of necessity take into account the heterogeneous nature of activities. The sector covers such a large variety of activities that it is useful to break it down into sub-groups and sectors for operational purposes. Different types of informal activity require different measures of assistance depending on, for instance, scale of operation, means of production or entrepreneurial skills required. This means that the right combination of assistance measures has to be decided case by case.

It has been the case that most support programmes often try to give utmost priority to the creation of credit schemes in response to the widely held perception that credit is the most pressing input constraint. However, some contend that the relative importance of these schemes government development banks and finance companies; commercial banks; credit and saving institutions, etc. Moreover, financial support can be individualistic or group-based and/or minimalist (financial support only) or integrated (including technical assistance, training, etc.).

Assistance with informal sector financing in developing countries is an area where noticeable progress was made in the past two decades. However, in spite of the progress achieved, the issue of access to credit for these units is far from resolved. The evolution of financing schemes in the past are treated in what follows.

2.1 The Conventional Approaches

2.1.1 Development Finance Companies (DFCs)

Until the mid-70s, the most important source of finance for small and informal businesses was from government development banks and finance companies which have assumed various forms in different countries. The most important being Development Finance Companies (DFCs) that were the first to establish institutional credit facilities for small enterprises, albeit on a modest basis. The World Bank used these in earlier projects in, for example, Cameroon, Colombia, the Republic of Korea, and the Philippines.

However, after the mid-70s, it soon became clear that using DFCs as the only source of financing small and informal enterprises had some operational problems- mostly too much centralization and slow appraisals- and serious financial problems of their own. One remedial measure proposed particularly in French-Speaking African countries has been to abolish the classic distinction of functions between DFCs and commercial banks.

2.1.2 Commercial Banks (CBs)

Private financial institutions such as commercial banks emerged in the past decade as a potentially useful alternative source of credit for small and informal enterprises. In some countries, such as Indonesia, the commercial banking system has become the most important source of term loans to these enterprises for both investment and permanent working capital.

One major advantage is the large branch network of CBs, permitting-most importantly- direct knowledge of, and frequent contact with, entrepreneurs in their local environment. Furthermore, they are usually able to offer a greater variety of banking services, and are more experienced in debt collection than DFCs or government development banks.

However, CBs tend to perceive loans to small enterprises as particularly risky and involving prohibitively high administrative costs. This is primarily because these enterprises cannot provide sufficient collateral of material security in the form that the institutions are accustomed to obtain from borrowers.

a guarantee to cover some or all of the losses incurred when borrowers default. Here, in effect we are referring to the interactive role of either governments, groups and/or NGOs as catalysts and intermediaries in easing the accessibility of financial institutions to the enterprises.

2.2.1 Government-guaranteed Lending

A variety of arrangements has been observed as to who constitute the source of the guarantee fund. The most frequently observed form is a Credit Guarantee Fund (CGF) set up usually with government financial support to provide the money to compensate for the default (or accepting commitment by the government as opposed to setting up specific fund).

The most significant decision that has to be made in launching a guarantee scheme relates to the proportion of risk that will be covered by the funding organization. In some cases, as in Japan, France and a few other industrialized countries 100% of the risk was shared by the fund. There is however the contention that lending institutions should assume some risk, but it must not be as high a proportion as it discourages them.

Such schemes are initially developed in Europe and are being overwhelmingly practised in France, Italy, Britain, and the Netherlands with some success. Although there is some experience from developed countries, and from India and from the Republic of Korea, data from LDCs is insufficient for a full analysis of the factors determining the success or failure of CGFs. The consensus of opinion is that informal sector development in developing countries requires measures and programmes involving expenditure from the government budget in the form of a subsidy of one kind or other.

Most LDCs have therefore established CGF's most of which were established by governments, usually covering an important part (70 to 80 per cent) of the default risk. The limited experience of setting up of government-funded guarantee schemes in developing countries shows that generally they have not proved very successful. The various measures to that effect have not had the desired effect, except in a few countries such as India.

These schemes generally face two problems: one is their viability, and the second concerns whether or not they actually contribute to additional lending to the targeted clientele. This approach appears to be feasible when private financial institutions adopt them, but when it is adopted by a publicly funded development programme the end result is often to cover the defaulted loans from the government budget. A recent analysis of a microenterprise programme in the Gambia, the Indigenous Business Advisory Service (IBAS), as an example, shows that the most common reasons for the failure include:

- the inability of the programmes to secure the confidence of the banks that claims will be honoured, without delay and without prolonged argument about the quality of bank supervision;

Grameen Bank in Bangladesh. This can be more effective where the members have their own constitutional arrangement to make pressure on whoever defaults.

Second, the contribution of the members towards the creation of the basic fund of the association represent important savings on their part. Finally, one of the important elements of the MGSs, particularly in LDCs, is the chance of extending mutual support promoted within this type of self-help to areas of activities other than financial ones.

But, it should be remembered from the outset that the MGS can function as financial intermediary between the banks and the borrowers instead of the government or donor agencies does not mean that the government should disappear from the scene. Governments have usually supported the schemes by, for instance, providing reguarantee, which provide financial institutions with additional security, and by providing part of the capital needed to start the scheme. The appropriate approach is for the government to match the contribution raised by the group members from other sources in an agreed ratio.

The literature provides evidence of some successes, but also failures, in following the group approach. The Grameen Bank is the most important and widely applied group-based credit programme which has found fertile ground in many parts of the world from Asia to the cities of North America, and it is a case of most successfully implemented lending model in Asia (notably in Bangladesh).

Notwithstanding the great effort to replicate the Grameen Model in many parts of the developing world, the examples in Africa remain few. The Malawi Mudzi Fund is a Grameen replication Programme which began granting loans in 1990, but it now appears to be experiencing fundamental problems.

One of the donor organizations which has made a special effort to help establish these schemes is the Friedrich Ebert Stiftung (FES), a German foundation working in LDCs with aids of funds from the German government. Although the FES believes primarily in the use of CGAs, its reports indicate that it has encountered special difficulties in introducing the approach. It has helped to set up guarantee schemes in various countries including Kenya, Honduras, Chile and Senegal, to quote only few examples. Perhaps the most interesting case is the attempt in Kenya during 1983-1987.

The Kenyan experience shows that there is an inadequate understanding of the limitations and obligations of a CGA, and that there is unrealistic expectations on both sides, the reluctance of the target groups to be involved in self-help and mutual support activities. It was also observed that the banking sector was not sufficiently aware of the potential of such schemes, and hence was not co-operative. It is however important to recall the fact that those who took part recognized the value of savings and independent capital formation, and viewed the creation of the funds in this light.

The most recent NGO-run credit programme in Kenya, substantially modelled on the Grameen Bank, shows that a group-based approach can be effective if it finds cultural grounds with in the community. It has also indicated that the establishment of sound group practices for effective credit repayment and sustainability is not only built on institutional effectiveness and commercial viability, but also achieved through the establishment of groups in which participation and trust are built, and that this is attuned to community values inherent in traditional African culture.

What is more, ideally, groups formed by the credit programmes can not be simply credit groups but must be community groups for self-help, self-determination and self-reliant development building on the established tradition. This experience of Kenya, however, shows that the transformation from social welfare credit to commercially viable credit and the building of viable financial institutions takes time.

The fact that the solidarity group innovation helps to improve the repayment performance is out of question, but loan supervision remains a time-consuming and implicitly costly operation when undertaken by NGOs. In each of the PISCES-II projects (funded by USAID) administration of the credit fund was difficult since small local NGOs have little experience in administering loans (Harold Lubell, 1991).

Moreover, some experts believe that NGOs will encounter similar problems to those faced by governments if they enlarge the scope of their operations beyond local levels. There is also the problem of programme continuity when institutional assistance is withdrawn and the project has to rely on local resources.

In this regard, the experience of some Asian countries shows that NGOs cannot achieve much in isolation but need to work with commercial banks, with other programmes designed to promote enterprise development and with government.

NGO credit supply programmes are conceived not only as immediate relief measures, but used as an instrument for providing access to the formal banking sector. Over the past decade several NGOs in L. America have expanded their credit to the point where they have been forced to seek new sources of finance than only from the donor agencies, as such sources proved inadequate in volume and too slow in processing.

Some NGOs have, accordingly, links with formal financial institutions in their own country, or have established independent banking or credit organizations, and are able to mobilize an increased flow of funds. ADEMI in the Dominican Republic, Paraguayan Foundation in Paraguay, ADMIC in Mexico, and ACTUAR in Colombia are some of such NGOs. Another example from Africa is GAPI in Mozambique, the FES-run consulting office which is now in a process of transformation into a full-fledged financial institution for microenterprises.

Whilst some of the ground work is being done in terms of NGO mediating between clients and the banks in the graduation of successful enterprises, and this has helped some microenterprises

The major characteristics of such integrated approaches is that government financial support and subsidies are not considered permanent and should therefore not be relied upon; the main justification being self-sustainability of the enterprises. The other reason forwarded is the inadequacy of the provision of services by non-financial institutions. In many cases the performance of these institutions was poor and enterprises tended to shy away from the bureaucratic practices involved.

It is therefore not surprising that financial institutions became increasingly inclined, as they could rely on themselves, to provide better quality and delivery of at least a minimum of non-financial assistance to their clients (in spite of the possible disadvantages, costs and risks).

If a technical and financial components are to be merged into one programme, the question remains as to how the two components will be co-ordinated for maximum benefit to participants. It is also necessary to consider the general consensus that cost-effective ways of extending technical assistance to the mass of informal sector participants have not yet been found (Neck and Nelson, 1987; Harold Lubell, 1991; Malcolm Harper, 1992).

The extent to which technical assistance should be a part of financial assistance and whether specific training should be a prerequisite for financial assistance are, therefore, still outstanding questions.

Experience with a considerable number of microenterpeise support programmes has shown that minimalist credit programmes, those with little or no training and technical component added to the credit component, have been successful in increasing and maintaining the incomes of their borrowers (Harold Lubell, 1991).

The 1989 USAID evaluation report on 38 projects in 20 countries all over the Third World has concluded that the so-called minimalist credit model has a better record of achievement than the more ambitious transformational programmes. The more recent experience of working minimalist approach in Kenya is also in support of this evidence, though some problems have been observed.

However, some feel that the success of such minimalist programmes may be due partly to the fact that funds are limited so that the credit is rationed to the more competent potential borrowers by the process of selecting among candidates for loans. An exception would appear to be the Grameen Bank of Bangladesh, whose loans are extremely small and whose borrowers extremely numerous. Others have contended that the needs of the vast majority of microenterprises cannot be satisfied merely by the provision of small working capital. It is still not clear how to meet the needs of less viable enterprises on a cost-effective basis.

The other most common sources of informal credit has been the traditional social groups which play crucial role not only for business financing, but also in the economy of most members of the country. In Ethiopia a variety of traditional resource mobilization and saving mechanisms exist in both urban and rural communities. Such traditional and social financial institutions have deep rooted social and cultural origins and include ***Ikub*** (a lottery-based resource mobilization), *Idir* (much larger and with a purpose of pooling resources for future crisis), and ***Mahiber*** (with social objective similar to Idir).

The bad news is that most of the funds mobilized are spent on consumption rather than on productive and investment purposes. There is, therefore, a large room, on the one hand, to exploit such traditional social groupings as a means of easily introducing group activities, and, on the other, to divert resources for the self-sustaining activities on the part of the community.

In general, institutional, traditional and cultural barriers represent forces that hinder many classes of informal enterprises from participating actively in formal credit markets. Some studies based on limited surveys indicate that the underdeveloped nature of financial institutions, government financial policy, and the immature potential in entrepreneurship handicap these enterprises.

The overall lending and credit policy in the past was against the private sector in general, and it has had no role as far as the informal sector is concerned. Whatever credit was available, to small enterprises, it was provided to registered service or producer co-operatives. Lack of registration on the part of the informal enterprises has therefore partly prevented the sector from getting access to formal credit.

Therefore, it is only if the right environment is created for the informal sector participant that they can facilitate the utilization of indigenous resources, generate substantial employment, etc. Therefore, the development of small and informal enterprises in Ethiopia calls for the creation of the right environment, appropriate policy measures and diverse institutional supports.

Presently there is a tendency of liberalizing the economy, which can be considered as a first right move to place the informal sector on equal footing with the organized sector. Very recently the TGE appears to be concerned to tackle the alarming problem of unemployment by an integrated development strategy. The formulation and implementation of an integrated and sustainable employment generating programme may be a step in this direction.

The private formal sector employment could not expand to any meaningful extent due to several policy and administrative constraints. Generally, assessment of the available employment data indicates that there are limited wage employment opportunities. Moreover, in the light of the enormous number of the demobilized army and the retrenchment of a number of civil servants due to the implementation of SAP, the prospect of the informal sector to create productive employment cannot be overemphasised. Besides, given the severe shortages of capital,

- This would entail vigorous promotion of group-based credit in the context of a community development approaches. The enterprises should be encouraged to organize themselves voluntarily on a self-help basis that may help in reducing costs of promotion, allow for more aggressive follow-up and collection efforts, and above all, providing important information to officials on client needs.

- collaboration with funding and donor agencies and NGOs should be enhanced, particularly the role of NGOs as an intermediary between lending institutions and the clients should be promoted. NGOs should be encouraged to participate actively in financial programmes, particularly those aimed at special target groups and sectors in which the special characteristics of NGOs make them extremely valuable collaborators.

- The main lesson is probably that great caution should be exercised in developing credit programmes. The whole review of the economics of credit reveals one important lesson above everything else: that there are many distinct approaches to micro-credit. The question of choice is one of relevance. The choice of appropriate system should be based not on ideology nor on precedent, but on what is suitable for local situations. The institutions that may evolve and the organizational culture should be in accordance with the unique environment of the operation of the programmes. The respective roles of the institutions need to be identified accordingly.

4. CONCLUSION

It is widely recognized that the informal sector of a country may significantly contribute to development if it is properly exploited, and if the necessary support is given to the sector. There exist a broad spectrum of interventions that could be used to promote the activities in the sector. In designing the appropriate approach, consideration needs to be given to the viability of whatever measure is taken to the peculiar nature of the enterprises in the country. Decision must be based not on what is done in this or that programme elsewhere but on what is most suitable for Ethiopia. The mere replication of the method developed elsewhere, regardless of local circumstances will almost certainly be doom to failure. Therefore, a wider appreciation of the need to design an appropriate approach should be emphasised.

A crucial issue in determining which form of direct interventions is most appropriate is the identification of the key constraints facing the enterprises. When asked to identify their primary constraint, informal enterprises will usually state that it is the lack of credit. Yet in-depth analysis frequently reveals that other constraints may be more crucial. A detailed research and analysis need to be carried out to identify the types and forms of assistance most needed by the enterprises.