

THE INFORMAL AND FORMAL SECTOR ENTERPRISES: THE DYNAMICS OF LINKAGES UNDER POLICY REFORM

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1. INTRODUCTION

In the last two decades, the Ethiopian economy has been in a crisis due to unfavourable internal and external conditions. At the center of the economic problems were and still are structural dislocations exacerbated by wrong economic policies, recurrent droughts and civil wars. Unfavourable domestic policies have caused economic, social and environmental deterioration. The mismanagement of the economy has further led to the neglect of the productive sectors resulting in declining output and employment. The country also suffered from negative terms of trade and rising debt burden which widened the current account deficit. With slow growth and rapidly expanding population, per capita income has been reduced, leaving the poor close to starvation.

To reverse this trend, the TGE has issued a New Economic Policy Reform Programme. The programme is aimed at creating favourable conditions for economic growth. The reform package is intended to remove the current account deficit, to rectify market distortions, to stabilize prices and abate inflation, and to attain long-term economic growth. A number of policy instruments have been designed to realize the goals of the reform programme. Some of these instruments include exchange rate policy, monetary policy, fiscal policy, interest rate, trade liberalization, price deregulation, public enterprise restructuring and privatization, customs tariffs regulation etc.

The objective of this paper is to analyse the impact of the economic policy reform programme on the formal-informal sector linkages, with due emphasis on the latter. Linkages have been identified as direct and indirect, backward and forward, technological and consumption for analytical purposes. Using the cases of informal shoe-makers and tailors, some preliminary observations are drawn here. Where information is lacking, the experiences of other countries that have implemented Structural Adjustment Programme have been considered.

Based on these observations and experiences, certain conclusions and recommendations have been made with a view to develop and revitalize the informal enterprises in Ethiopia.

2. FORMAL-INFORMAL SECTOR LINKAGES

The formal and informal sector linkages assume several forms. The important ones are backward and forward linkages, consumption and technological linkages(ECA, 1991, p.15). A backward linkages involves supplying of inputs to the informal sector by the formal sector, while

sector activities. However, when faced with shortages of raw materials, informal firms resort to other informal establishments.

With respect to labor input, there is a close linkage between the two sectors. The informal sector entrepreneurs usually originate from the formal sector. Working proprietors are usually involved in other economic activities and provide supervisory assistance in their workshops. Some of the proprietors maintain their employment in the formal sector (ILO/JASPA, 1986, p.15). This type of dual operation is prevalent in the informal sector. Due to skill and technical requirements of operations, and problems of spare-parts, the informal enterprises maintain regular contact with the formal sector (ILO/JASPA, 1986, p.15).

The labor input of the informal enterprises can be subdivided into four categories. These are working proprietors, hired workers, unpaid family workers, and apprentices. It may be said that paid employees are originally trained within formal enterprises as apprentices. Once these apprentices gather enough experience, skill and initial capital, they set up their own businesses as entrepreneurs (ILO/JASPA, 1986, p.17). The use of apprentices has of course the advantage of reducing wage payment and the cost of operation in the enterprise. In addition, apprenticeship is a means of skill formation, preparing apprentices for employment within the informal or formal sectors (ILO/JASPA, 1986, p.17). Also the formal sector serves as a source of skilled workers for the informal sector. Thus, there is strong backward linkage between the formal and informal sectors both in the factor and product markets. In the other markets, the linkage is more pronounced within the informal sector enterprises. There is, for example, more flow of credits among enterprises within the informal sector.

2.1.2 Forward Linkage

This is a linkage expressed in terms of sales from informal to formal sector enterprises. Recent studies of the informal sector in Francophone Africa indicate that the forward linkages are weaker than the backward linkages. The informal enterprises sell little to formal enterprises (ECA, 1991, p.16). The studies further reveal that the informal sector produces goods and services for the urban poor who are engaged both in the formal and informal activities. These goods and services are considered to be "inferior" since they are associated with high income elasticities. In other words, the goods and services of the informal sector do not have high demand by the rich (ECA, 1991, p.16).

2.2 Technological Linkages

The technological linkages between the formal and informal sectors are reflected in various forms of transfers. The exchange of machinery and equipment, for example, involves flow of technology and know-how. This transfer is usually categorized as a backward linkage. This linkage is of critical importance if it is large enough to increase capital-intensity that enhances

In the forgoing sections, attempts were made to show the various forms of linkages between the formal and informal sectors. The investigation of the nature of the linkages is an important step in the discovery of the growth potentials of informal sector. It is believed that linkages are best studied for specific activities, specific objectives and in specific time and space (ECA, 1991, p.17). In the ensuing section, the paper is tuned to identify specific linkages for economic development and for policy intervention and accordingly we present the implications of economic policy reform on the formal and informal sectors in general, and on shoe-making and tailoring activities in particular.

3. POLICY REFORM IMPLICATIONS

3.1 Why Policy Reform?

The Ethiopian economy has persistently declined into a serious crisis during the past two decades. At the core of the economic problems were and still are structural distortions, aggravated by wrong policies and by unfavourable circumstances in the world economy. Arbitrary political interferences into the economic process led to the mismanagement of the productive sectors and resources, price distortions, over-valuation of the currency, declining output and employment, rising debt burden, budgetary imbalances and deficits in the balance of payments. Of course, recurrent droughts and civil wars have further exacerbated the economic problems of the country.

To reverse the crippling effects of these structural problems, the TGE has put in place a New Economic Policy. The Policy succinctly stipulates the reduced economic role of the State, limiting it to regulatory functions, while the private sector would play a leading role in a market driven economy. This policy has been reinforced by a series of reform measures.

3.2 Features of the Economic Reform Package

Consistent with the New Economic Policy, the TGE has come out with a reform programme for immediate implementation. The elements of the reform package include: the exchange rate policy, monetary policy, interest rate, fiscal policy, trade liberalization, price deregulation, public enterprise restructuring and privatization, investment law, labor law, transport deregulation, customs tariffs regulation and sales and excise tax administration.

The main goals of the short-term reform programme are:-

- i) removing the current account deficit by increasing exports and reducing imports;
- ii) eliminating market distortions;

- d. At the stage of policy design, little attention was paid to the interlinked areas of policy intervention. This resulted in the implementation of contradictory policies which led to reform failures;
- e. Reforms suffered from the responses of the target-groups. Both the agricultural sector and the private sector have not responded as anticipated. Agricultural responses to prices and exchange rates were slow while the private sector rarely used the opportunities offered through liberalization. The private sector was weak and ill-prepared to respond to policy stimuli. It has been reported, however, that in Nigeria, the private businesses forced the government to abolish a liberalized import-tariff structure since they could not compete with imported goods. Thus, lack of enthusiasm on the part of the target-groups slowed down the implementation of economic reform.

In most of the cases reviewed, failure in policy implementation could be attributed to insufficient policy design, strong political interference, economic scarcity and inadequate response of the target-groups (Peters-Berries, 1993, p.17).

3.3 The Impact of the Economic Reform Programme on the Informal Sector

Though no official articulation has been made to pursue an active policy towards the informal sector, it is implied that the economic reform programme (ERP) involves the informal sector. Some of the elements of the policy package seek to mobilize indigenous resources which are normally employed by the informal enterprises. The poverty alleviation programmes of SDA, which are implemented in conjunction with the economic reform package, include measures that affect the informal sector.

The mere size and importance of the informal sector has a decisive impact on the implementation of ERP. In sub-Saharan Africa the size and structure of the informal sector was hampering some of the SAP reforms. Tax, credit and monetary policies had little relevance to the informal sector; but since this sector constituted a larger part of the economy, the SAP measures had limited impact on the economy as a whole.

As experienced in sub-Saharan Africa, SAP measures were successfully implemented in the areas of price changes, currency devaluation and monetary policies. Where liberalization of prices was effectively introduced, petty traders were disaffected since parallel markets, which flourished under a controlled economic system, might disappear (Peters-Berries, 1993, p.18). On the other hand, with the abolition of price distortions, discriminating the informal sector, new business ventures come into being and a wider range of commodities might appear on the market (Peters-Berries, 1993, p.18). Some studies suggest that the removal of price controls have a stimulating effect on the informal sector.

4. THE DYNAMICS OF LINKAGE UNDER POLICY REFORMS IN ETHIOPIA

4.1 Expected Trends

We will briefly review here the likely impacts of certain economic reform measures taken by the TGE in relation to the formal and informal private sector enterprises. One of the measures to be considered here is trade liberalization and its impact on the private sector. Trade policy may be divided into exchange rate, import and export policies. Regarding the exchange rate policy, the Birr was devalued by 140 percent in October, 1992; and the foreign exchange auction was introduced on May 1, 1993. Though time is short and data is not available, it is fairly expected that the informal sector would be affected by these measures. The foreign exchange auction favours public enterprises multi-nationals and big private businesses that could afford US\$5000, the minimum amount of money required to participate in the auction. The auction process requires licenses, import permits and other credentials for the lack of which informal enterprises are deemed ineligible. The auction system may succeed in eliminating the black market for foreign exchange but the informal enterprise that need foreign exchange for the purchase of spare-parts, equipment and tools would be negatively affected. However, the need for foreign exchange in the informal sector may not be that big to affect the whole sector as such.

With the devaluation of the Birr, the system of foreign exchange allocation was abolished. Both measures are expected to increase prices of imported raw materials, which in turn reduce the demand for formal and informal sector import-intensive products. Moreover, the liberalization of foreign exchange market put a number of public enterprises, which enjoyed preferential treatment under the previous regime, into jeopardy. The public enterprises that used to supply raw materials, directly or indirectly, might be closed down or reduce their scale of operation and force a number of informal enterprises out of business.

Since the economic reform advocates the liberalization of imports, it may reduce the demand for locally produced goods including those by the informal sector. Imported consumer goods, especially clothing and footwear, are in some cases cheaper and their use had higher prestige associated with quality. The devaluation of the Birr does not seem to protect the market for local products since most of the small-scale industries and informal enterprises are, in some cases, import dependent. Devaluation, therefore, tends to increase their cost of production. They would be forced to be inward-looking in the application of indigenous resources and technologies.

It is reckoned, on the other hand, that import liberalization would increase the amount and variety of imported spare-parts, raw materials and tools available and this will improve the productivity of small enterprises engaged in manufacturing, construction, repair service and garages.

rates to cover costs and surpluses. Usually, the lending involves small amount of money which does not need refinancing through the banking system.

We can safely assume that the monetary policy has no immediate and direct impact on the informal sector. Because the reform is not intended for the informal sector, which comprises a substantial part of the economy, the monetary policy may have a limited impact on the desired structural adjustment in the economy.

Fiscal policy is also an element of the reform package that would correct budgetary imbalances. This, policy, through public expenditure, has a direct impact on the informal sector. Through spending on social and physical infrastructure, it enhances the informal and small-scale enterprises. Also through salaries and wages paid to workers of state enterprises and civil servants, who are customers of informal enterprises, the government stimulates informal sector activities. However, the ERP that aims at reducing budgetary deficits, cut public spending as a cost-saving measure. With public expenditure reduction, wage-bills would be curbed and the purchasing power of public sector employees might be eroded. With income reduced there may be a shift in demand from products of the formal sector to that of the informal sector, which are cheaply produced. Furthermore, cuts in public expenditure might force the retrenchment of skilled workers from the public sector to seek employment in the informal sector.

Reduction in public expenditure might affect social services like health and education. With deterioration in health services, and shortage of medicines, there may be a tendency to opt for traditional medicines and quack doctors. Decline in the standard of education in public schools result in the supply of reduced-quality graduates that join the labor force. With unemployed youth, lacking specialized skills, it would be difficult to develop informal micro enterprises in the country.

4.2 Formal-Informal Sector Linkages: The Case of Shoe-making and Tailoring in Addis Ababa

4.2.1 The Shoe-Making Enterprises

A substantial number of shoe-making enterprises are located in Addis Ababa. Wereda 5, which is part of the largest trading center, Mercato, of the capital city. An attempt is made here to depict the business operations and linkages in the trade. The case of a typical entrepreneur, who migrated from a rural region to the city in search of employment and joined a formal shoe enterprise owned by a relative, is presented here. He earned meager income as an apprentice and later on elevated himself, through hard-work and dexterity, into a skilled shoe-maker. With accumulated experience and little savings, he started his own business with capital obtained through mutual aid association, and contributions made by relatives and friends (The Informal Sector, 1993).

licensed dealers. These dealers transfer the cost of their operations and profit margin on to the informal tailors who do not have direct access to manufacturers. Such a chain of supply of inputs raises the cost of tailoring (The Informal Sector, 1993).

Other inputs such as sewing machines, spare-parts and hand tools are obtained from importers. This reveals that the technological linkage is indirect and involves foreign exchange which is not available for the informal entrepreneurs.

Informal tailors hire skilled workers and engage unpaid family workers. Sometime, skilled-workers who own sewing machines are sub-contracted to perform certain tailoring activities. Payment is effected on a piece-rate basis. The skilled workers usually are employed formal tailoring enterprises; and they are treated as casual labourers. There is a free mobility of labor among tailoring enterprises, both formal and informal.

Informal tailors have closely linked with vendors who sell clothes on the streets or in the rural areas. Peasants are the major consumers of locally produced clothes. However, in recent time this consumption linkage has been disrupted by imported, fashionable second-hand clothes that are sold for cheaper prices than the domestically produced clothes (The Informal Sector, 1993). These second-hand clothes have flooded the market after the declaration of mixed economic policy in March, 1990. This influx has been fuelled by the new policy of trade liberalization. With reduced tariff on imports and smuggling of clothes the tailoring businesses have been brought to the brink of ruin. Some converted their businesses into retail trade and building material shops. Some sold their sewing machines and other equipment to those who are newly engaged in tailoring second-hand clothes to the size of customers. Some exchanged rental titles to their shops with money to cover accumulated rents.

With high interest rates and low import barriers, businesses are unable to compete with goods flooding from abroad. The government, therefore, will have to consider anti-dumping duties on selected imports to protect businesses and workers from unfair foreign competition.

The informal sector, being flexible and convertible, cushions itself against unforeseen circumstances. But this requires some kind of savings or source of income such as mutual aid associations and contributions by relatives. Those who do not have such opportunities are forced to change their trade and craft and start all over again as apprentices or they simply perish.

This crisis has not been restricted to the informal tailoring enterprises. It has affected negatively the whole backward linkage. Suppliers of textiles have not been able to remain in business since they have no outlet to the accumulated stocks which they have acquired from the textile manufacturing industries. The public enterprises that are engaged in the manufacturing of textile products, twills, yarn and threads have in turn been grinding to a stand-still. Importers and suppliers of sewing and knitting machines have registered a decline in sales activities. One

access to finance, material resources, physical security of production, educational and managerial skills (Peters-Berries, 1993, p.2). Therefore, it is necessary to promote and support the IS through specifically designed policies and programmes.

The economic reform programme and the IS responses reflect a certain degree of incompatibility. Governments have been attempting to curb IS activities as a result of which informal entrepreneurs have become suspicious of the government and avoided it at all costs. Thus they are unresponsive to Government policies. Therefore, it is difficult to make the informal enterprises targets of economic strategy. The government is cautioned against undue optimism in designing policies towards the informal sector. It is, therefore, imperative to investigate the peculiarities and special interests of the IS. The climate in which policies are implemented has to be grasped before putting policies into action.

It is also necessary to evaluate the impact of the ERP on the informal sector. The implementation analysis of ERP would enable policy-makers to feel the sensitivities and characteristics of the IS. It also helps to assess the actual and indirect impact of the programme on the IS.

With trade liberalization, reduced tariffs and low import barriers, informal enterprises and formal small businesses would not be able to compete with imported commodities. This is particularly true of those engaged in tailoring, weaving, and knit-wear production that are nearly out of business. Their linkages with textile manufacturers and suppliers of sewing and knitting machines are also negatively affected. Thus, backward and forward linkages, technological and consumption linkages are disrupted. Policy-makers may, therefore, take heed not strategies that strengthen the formal-informal sector linkages for enhancing economic development.

Based on the preceding discussion, the following recommendations are extended:

- i) The government should give official recognition to the informal sector as a productive and strategic economic agent that may be considered as a target of economic reform programme. This is useful in countering harassment of the sector by local authorities, and in coordinating the different branches of the government towards the development of the sector.
- ii) The government should promote and support the informal sector through specifically designed policies and programmes. Thus, the government may consider the following strategies that would strengthen formal-informal sector linkages.
 - a. Provide government contracts to informal operators and enhance the re-distribution of income to employees who are consuming goods and services produced by the IS.

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