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SMALL AND MEDIUM ENTERPRISE POLICY REFORMS AND FORMALIZATION PERFORMANCE IN NIGERIA

A Difference- Principle Approach.

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Abstract

In this study we employ the “Difference Principle” approach to evaluate the costs and benefits of firms transiting from an informal to formal sector (Formalization).

We focus on both the differential impacts and effectiveness of policy reforms such as microfinance policy and other related micro-enterprise policies aimed at attracting informal firms into the formal sector. Introduction of Institutional reforms presupposes that firms in the informal sector maximizes a given welfare condition which acts as an incentive to formalize.

We test this assumption through assessment of the welfare impacts of formalization on stakeholders and its implications for employment generation, poverty reduction and income distribution. It is envisaged that the outcome of this study will assist small and medium scale enterprise policy makers to critically evaluate and update their policy prescriptions against the background of their actual impact in persuading informal sectors to formalize especially from the perspective of policy costs and benefits.

Keywords: Small and Medium Enterprises, Difference Principle Approach, Policy

Note: This is a working Paper and the results are not yet conclusive. Comments are welcomed to improve the final version of the paper. We take responsibility of all errors.

1. Introduction:

The informal sector connotes dual nature of organization of production activities characterized mainly by low-productivity sectors, co-existing with higher- productivity ones. The preponderance of informal production methods is often associated with developing economies because of dual nature of their economies. For instance, Ihrig and Moe (2000), notes that while 17 per cent of the work force in OECD countries operates in the informal sector, this figure, in developing countries rises to 60 percent. However, given the opaque nature of the operations of the informal sector, including their inability to report their activities accurately, figures on the actual size of the informal economy are therefore hard to come by. Estimates suggest that the size of the sector in the developing world is large, accounting for between 30-70 percent of GNP (Jagannathan 1987).

Notably, the informal sector is smaller in Hong Kong (China) and Singapore and higher in Egypt, Morocco, Peru, and the Philippines (Galal 2004). From the foregoing, an analogy could be made that the level of development and the degree of informality appear to be negatively correlated. However, for developing economies, even if the 30 percent lower bound is taken as a benchmark, it is still costly for these economies to have one- third of their economies operating sub- optimally because of the obvious distortions it imposes on the effectiveness of macroeconomic and development policies.

In the case of Nigeria, some studies have estimated the size of the informal sector to be around 60 percent of the GDP (CBN and NBS, 2003; National Planning Commission, 2005). As the search for the sustainable development of the Nigerian economy progresses, a large size of the informal sector is a source of concern for obvious reasons one of which is its implication on the sustainable management of resources, policy effectiveness and poverty reduction strategies. Historically, prior to the 1970s the informal sector in Nigeria was not considered as a separate sector. Their activities were classified variously as “traditional crafts” and “petty trade” in subsistence sector, or as small-scale industries within the formal sector, and treated as such (Wake 2005). Some effort was made to upgrade what was considered their low level of productivity and low standard of workmanship through the establishment of Small Industries Development Centre (IDC), and later the Small-Scale Industry Credit Scheme (SSICS), to provide technical advice and training, and to offer small loans. However, no effort was made to protect informal sector products from competition with imported and mass-produced goods, hence informal sector remained largely underdeveloped and tended to currently dominate the formal sector.

Dessy (2001) underscores the foregoing, noting that it makes no sense, for whatever reason, to ignore the fact that a significant proportion of the economy-wide resources remains trapped in the low- productivity, informal sector. In this context, *Formalization* is therefore considered compelling. This is because it offers solutions for the myriad of distortions that informality imposes on the economy, having to deal with a large informal sector with little available information about their true operations. It is expected that institutional reforms in the informal sector will fast-track formalization processes, which will ultimately de-marginalize and accommodate entrepreneurs outside the formal sector into formal economic activities.

This will provide essential clue to how economic policies can be better managed and transmitted, including improvement in their efficiency in addressing identified economic problems. This is made more urgent by the fact that developed societies have worked hard to reduce to the barest minimum the size of their economies that operate informally. Thus, drastically reducing the costs it imposes on economic management of resources, instruments and policies.

Though, it is believed that formalization is hinged on institutional reforms such as protection of property rights and other regulatory innovations which enable entrepreneurs secure inputs at low costs, secure increased access to infrastructure services and credit, take advantage of expanded markets, and avoid coping with unofficial payments to stay formal, however, there are obviously certain attraction in the informal sector that does not automatically ensure that all informal firms will formalize their operations given the aforementioned. Therefore, understanding these issues in our formalization processes is considered valid if the increasing informal sector is to be reduced to a manageable level. In addition, it has been equally argued that formalization equips and motivates entrepreneurs to expand their businesses, reorganize internally and benefit from specialization and division of labour leading to increased economic growth (Barro and Sala-i-Martin 1995; Knack and Keefers 1995) and poverty reduction (Dollar and Kraay 2001).

However, the anticipated benefits of formalization remain a subject of debate in literature. Even if one accepts the merits of formalization in principle, Galal (2005) observe that three key questions remain unanswered: how large are the expected benefits from formalization in a given society? who are the likely winners and losers? and what does it take to achieve these gains? These questions bring to focus issues that relate to the effectiveness and positive impact of policy reforms in persuading informal firms to formalize. It also addresses the issue of welfare gains on the stakeholders and the distributional impact of such gains among major stakeholders since policy makers are mindful of the Pareto optimal effects of policies on all segments of the society. It is argued that

without empirical satisfactory answers to these questions, policy makers may not take the necessary actions needed to persuade entrepreneurs to voluntarily prefer the formal sector to the informal one on a sustainable basis.

In the light of the foregoing, Galal (2005) further notes that policy makers face competing demands on their political capital; the case for paying attention to formalization over other reforms thus needs to be made within the context of its relative significance among other policy considerations competing for attention and resources. Since Policy makers do not necessarily attach equal weights to different groups in society, the potential winners and losers from formalization need to be identified, and policy makers need a reform package that can provide attractive incentives to target and persuade entrepreneurs in the informal sector to formalize.

This paper therefore intends to evaluate the behavior of Nigerian informal entrepreneurs in the context of current institutional regulatory framework aimed at formalizing their operations. It further attempts to estimate the welfare gains from formalization and identify the potential winners and losers from formalization reforms with a view to proffering solutions to the possible distortions created by growing informal sector in the management of the Nigerian economy.

1.1 Problem Statement

Most activities in the informal sector are often insulated from the rest of the formal economy with implications for effective macroeconomic policy and prudent resource management. For instance, such important economic issues as measurement of the gross domestic product, poor monetary policy transmission mechanisms and financial repression are some of the problems associated with the existence of large and opaque informal sector, especially in developing economies of which Nigeria is typical. Although, some have argued that in spite of the foregoing, informal sector (IS) remains an engine of economic growth and job creation in most developing economies (Blunch et al 2001), the issue remains that advanced economies have had their informal sector drastically reduced through appropriate formalization policies which may have enhanced the chances of realizing their growth potentials in a sustainable manner.

In spite of the foregoing, it is not debatable that the informal sector imposes some costs on resource management with obvious implication for economic growth because of the opaque nature of their operations. For instance, high business costs associated with informal economy are mainly caused by such factors as ill-designed and unstable rules and regulations (particularly in relation to taxation, labour policy and business registration). In addition, a lack of well-defined and secure property rights;

poor- quality or non-existent infrastructure and public services; deficient government capacity and resources to enforce laws and regulations; or lack of transparency, accountability and autonomy of government institutions; as well as a high degree of macroeconomic instability, unemployment and corruption all contribute to rising business costs that make informal sector production activities largely uncompetitive (Eggenberger- Argote, 2005). In other words, an economy is underdeveloped to the extent that its informal sector activities remained relatively unknown to the formal sector.

However, opinions differ on what should be the appropriate attitudes and policies towards the informal sector in Nigeria. Some optimists tend to romanticize and eulogize the sector as a form of a popular development- a vital source of employment and income for the poor; the seedbed of the local entrepreneurs, and potent instrument in the campaign to combat poverty and social exclusion (Nwaka 2005). Others are of the view that the notion that the sector is easy to enter and requiring little money and skills captures the unique characteristics of developing economies and should be accommodated as such because of the fragile and poor response to formal policy changes due to the dual nature of such economies. This is the underlying assumption that produced the misconception that the informal sector, especially in developing economies required no form of official support and should be allowed to remain the way they are since they cater for special groups unequipped to play in the formal sector.

Others argue that in a globalizing world it is inconceivable to entrench and purposely ignore the informal sector either by omission or commission. This is mainly because it is considered to have inefficient production systems, acts as a drag on sustained growth and deepens dualism all of which encourages low- productivity and makes the economy less competitive at both the regional and global levels. Therefore, there should be a conscious effort to integrate and continuously reduce the magnitude and impact of the informal sector in the overall economy. The effectiveness or otherwise of large number of regulations and policy reforms aimed at reducing the huge level of informal sector in Nigeria needs to be subjected to empirical investigation to ascertain why there is a plethora of micro enterprise reforms aimed at formalization, and yet the informal sector is still growing and dominating formal economic activities with obvious implications for growth and poverty reduction- estimated at about 54 percent of the population currently (NBS, 2006).

1.2 Research Questions

The research questions to guide our study are as follows: Why is the informal sector still dominant in the Nigerian economy despite various reform policies enunciated to formalize them? What is the potential impact of formalization policies (registration processes, credit access,

infrastructure, technology and tax policies to mention a few) employed as formalization policy incentives? What is the welfare impact of formalization so far in the Nigerian informal sector and what are its implications on economic performance, policy effectiveness and poverty reduction strategies?

1.3 Research Objectives.

The main objective of this paper is to evaluate the causes of the low transition of the informal to formal sector in Nigeria and to determine its consequences on the policy effectiveness and growth of the Nigerian economy. The specific objectives are as follows:

- Analyze the effectiveness of some current formalization policies (institutional reforms) and their impact in persuading informal businesses to formalize
- Identify the gainers and losers of the formalization process
- Determine the welfare implications of formalization so far on the stakeholders.

1.4 Justification for the Study

In Nigeria, contrary to what advocates of the deregulation had presumed, the economic recession of the 1980s and the austerity measures that accompanied IMF-imposed structural adjustment program policies affected the informal sector adversely on both the demand and the supply sides, as markets contracted and input costs rose. Reduction in public spending, declining real wages, and overall public-sector retrenchments swelled the ranks of the informal sector beyond its absorptive capacity. Many formal sector enterprises forged new links, sometimes exploitative links with the informal sector to cope with the difficulties of the economic crises. The borderline between the formal and informal sector became blurred. Government response to this situation was contradictory in some respects. On the one hand providing the incentives to the informal sector by the establishment of training and credit facilities, and on the other hand, repressing the formal sector through multiple taxation, cumbersome registration formalities and excessive collateral demand to access credit. The difference in terms of policy incentives and performance between the formal and informal sectors was like the difference between the “rock and the hard place”.

Some analysts suggest that the informal economy in Nigeria is large enough to permit, and diverse enough, to necessitate a wide range of different policy measures, allowing government to mix incentives, assistance, rehabilitation and persuasion among a wide range of other policies to induce transition from informal to formal sector. However, despite the many policy measures undertaken in between 1980s and 2006, the size of the informal sector in Nigeria is still disproportionately large with respect to the formal with far reaching implications for over all policy effectiveness in the management of the Nigerian economy.

1.5 Hypothesis to be tested

To conduct the study the following hypothesis will be tested:

- i. Current formalization policies are not sufficient to persuade informal operators to formalize.
- ii. There are more losers than gainers in formalization process in Nigeria
- iii. Formalization engenders welfare loss among Nigerians and therefore does not inspire rapid transition from informal to formal sector.

2.0 Review of Related Literature

2.1 Theory.

Though a generally accepted coherent theoretical description of the informal sector is still emerging, several concepts have been adopted by various authors for analyzing the phenomenon. As a concept, the informal sector was first introduced by Hart (1971), according to Beckers and Stoffers (1975). Kabra (1995) claims that the concept really builds upon the earlier concept of the "unorganized sector", which encompasses production units of small size, including handicrafts, which have a 'domestic or unorganized character' and may also be part of the 'non-monetary' sector of the economy as noted by GOI (1951).

Indeed, Kabra (1995) states that the informal Sector (IS) is a fussy one, noting that some thirty different terms have been used to describe the informal sector, including the "survival sector", "non-structured sector", and transitional activities etc. Bromley (1978) observes that the informal sector may have emerged as a spin-off of the dual economy literature, originating with Lewis (1954) and Hirschmann (1958), which conceptualized economic development as the emergence and growth of manufacturing sector (the "modern sector") through the absorption of labour being freed from agriculture (otherwise known as the "traditional sector), due to the more efficient means of production in the former. However, where as the dual economy (the "modern-traditional" dichotomy) literature mainly addressed the sectoral differences in terms of the technology applied, a somewhat later related literature focused more on the organization of the sectors (Sethuraman 1976). An example of the later literature is Greetz (1963) who examined the informal sector in Indonesia.

Differences in the theoretical approaches to understanding the concept of Informal sector have also changed over time in several dimensions, incorporating regional characteristics and other distinguishing features. For instance, whether the informal sector was a marginal or basic sector has been a debate in literature. In terms of its contribution to the entire economy, the informal sector has been conjectured as a basic rather than marginal in contributing to employment and output mainly through

proliferation of labour intensive undertakings, some of which are considered unprofitable for larger (formal) enterprises (William and Tumusiime-Mutebile 1978).

Initially, the informal sector was principally viewed as a transitional phenomenon but has recently come to be accepted as a more permanent phenomenon (Beckers and Stoffers 1995). This argument relates to the recent evidence that –contrary to what one might hypothesize under the more “traditional” view- the informal sector did not contract following economic reforms. On the contrary, the evidence suggests that – at least in Africa and Latin America – the informal sector actually shows expansionary tendencies following adjustment and reform policies (Tokman 1990).

Characterizing informal sector by the type of labour it employs was first done by the ILO (1972) Report, which successfully contrasted the characteristics of the informal sector from the formal ones. It characterized the informal sector by ease of entry, low resource- base, family ownership, small –scale, labour- intensive, adapted technology, unregulated but competitive markets, and informal processes of acquiring skills. However, it failed to adequately recognize that in addition to self-employment and family labour in various guises, wage labour (regular as well as casual) and apprentices, for example, were also a very important component of the informal sector.

The linkages of the informal to the formal sector was another issue that has not been adequately highlighted in the earlier literature, for example, the ILO (1972) study did not adequately recognize the linkages between the formal and informal sectors of the economy. The tendency had always been that the activities in the informal sector is not known to the formal and it is this basic lack of relationship that generate some of the structural problems associated with the dominance of informal over the formal sectors of the economy. Sethuraman (1981), Hugon (1991), were of the view that the relationship may have been that of either subordination or super ordination. However, the appropriate sequence is yet to be determined empirically.

2.1 Empirics.

The notion of informal sector in Africa was first discussed in a 1972 International Labour Organization (ILO) report on Kenya. In the report, it was highlighted that problems of employment in less developed economies is not one of unemployment but rather on employed workers who do not earn enough money to make a living. They were described as the “working poor” and their conceptual interpretation was based in opposition to formality and on the basis of their lack of access to the market and productive resources (see Tokman, 2007)

In the context of the ILO Kenya report, Dessy and Pallage (2001) observes that dualism in the organization of production activities is very pervasive in developing countries, with informal, low productivity methods coexisting with higher productivity, formal methods. Notably, while 17 per cent of the work force in OECD countries operate in the informal sector, this figure, in developing countries, rises to about 60 percent (Ihrig and Moe, 2000), buttressing the argument that rising informal productive activities in developing countries may not be unconnected with policy ineffectiveness in the areas of infrastructural, industrial, and technological backwardness associated with such economies.

However, there is a general agreement over the need to pay attention to the informal sector, on account of its importance with respect to employment and poverty reduction issues. The thrust and content of this intervention has suffered from lack of consensus on a common definition of what the informal sector actually denotes. This lack of shared conceptualization has also translated into lack of shared approach to solving the problems imposed by the informal sector in developing countries. One perspective of the informal sector is that of survival meaning that informal sector activity is the result of pressure exerted by a labour surplus for jobs, when good jobs, usually in the modern sectors, are scarce. The result is that people seek low productivity- low-income solutions by producing or selling anything that may provide for their survival.

Another viewpoint about the concept of informal sector has to do with globalization and changes to the international division of labor. The argument is that there is need for productive decentralization among countries. To deal with an increasingly unstable demand, modern enterprises adopt to the new environment by introducing more flexible productive systems and decentralizing productive and labour processes, which allow them to cut production costs and to externalize demand fluctuations. The informal sector provides an environment for this kind of production in most developing economies.

Approaches to solving the problems of informal sector have been bugged by the aforementioned heterogeneous nature of the concept of informal sector. Some authorities have classified the sector into two broad groups: non-wage employment and wage employment. Under non-wage employment, you find the self- employed (both micro-enterprises and own account) and work in family business; under the wage-employment, you find regular and casual workers, which include sub-contract workers and home-based workers. Closely related to the ambiguity in its definition is a disagreement on the degree of significance that should be attributed to the informal sector policy discussions – despite recent empirical evidence suggesting the economic importance of the sector (Charmes 2000)

The justification for increased attention of policy makers to the issue of informal sector is directed at the fact that the earnings and employment situation of informal sector is inferior to the formal sector workers. This contrasts the tendency of developing countries where recent years have seen an emergence of labour, which, by one or more of the previously discussed definitions, could be termed "informal". Specifically, rather than traditional street traders and vendors, which are well-known from developed and developing countries alike, the emergence of more flexible forms of employment in the emerging economies of the world (Blunch, et al 2001)

In the past few years, the Nigerian informal sector has been studied for several reasons. For instance, the collaborative effort between the Central Bank of Nigeria and the National Bureau of Statistics (2004) concentrated on a national survey to ascertain the size and complexity of the Nigerian informal sector. They found out that the size of the informal sector in Nigeria is about 60 percent of GDP.

Obiora and Ukpai (1998) studied the impact of cost accounting practices on the growth and development of the informal sector in Nigeria. The study found out that lack of proper cost accounting practices hampers the development of the informal sector especially in the Eastern geopolitical zone where there is a high concentration of micro-enterprises. Nwaka (2005) studied the development impact of urban informal sector in Nigeria. The study concludes that lack of appropriate reform policies in the urban informal sector hampers the growth and anticipated contribution of the sector to National development.

Ekpo and Umoh (2008) analyzed the nature and policy requirements of the informal sector in Nigeria. The study identified the several definitions of the sector and concluded that there is a gap in the development of appropriate policies to enhance the growth of the sector. However, to the best of our knowledge, there is no work that has undertaken the task of evaluating current institutional reform policies of the informal sector firms and their impact in speedy formalization of the sector in Nigeria. This is the gap our study wants to fill.

3.0 Analytical and Theoretical Framework

3.1 Analytical Framework.

Our analytical framework follows Galal (2005) who developed a framework that first started with asking questions of why so many street vendors, bakeries, hairdressers, retailers, and artisans of all kinds opt to stay outside the formal economy? What does it take to convince them to shift to the formal sector and stay there? and what are the welfare

implications of both decisions? Both institutive and formal answers can be derived from the above questions.

The institutive answers are derived from the perspectives of the entrepreneur; the decision to stay informal is often mistakenly interpreted as a mere reflection of the high cost of entry into the formal sector. An alternative and equally mistaken answer is that the choice of informality means that entrepreneurs find it difficult to abide by the formal rules and regulations governing taxation, labour, contract enforcement, securing inputs, and selling outputs to different buyers or that the preference for remaining informal is due to costly procedures of exiting the formal sector.

A more comprehensive and convincing view of the phenomenon of informality is that entrepreneurs decide to stay formal because the total cost of entry, operations and exit associated with joining the formal sector are greater than the potential benefits from being formal. They are willing to forgo the benefits of better protection of property rights and to bear the cost of extra legality (in the form of bribes, costly finance, and lack of good protection) because it is more beneficial to remain informal. The only way to convince entrepreneurs to formalize is for the government to introduce reforms that reduce costs and enhance the revenues for entrepreneurs to the point of tilting the balance in favour of formalization. The level and depth of this imbalance is an empirical question.

3.2 Theoretical framework

We employ the “**The difference principle**” to ascertain the level of imbalance between the informal environment and the impact of institutional reforms in the formal environment to attract firms to formalize. Basically, what matters for the entrepreneurs is not whether government reduces the cost of entry, operation or exit or simply takes measures to enhance revenues through tax exemptions or subsidized credit. Rather, it is the difference in the net benefits under two states of the world (Formal vs informal) that makes a difference. In other words, it reinforces the notion that reforming the business environment facing the formal sector is considered key in attracting entrepreneurs into the sector.

From society's perspective, entrepreneurs are only one group among many. The government also cares about workers, consumers, and its own budget as well. Accordingly, the policy maker's decision to promote formalization hinges on its impact on all of these actors. Formalization could, of course, impact positively on certain groups and negatively on others, just like other policy reforms. However, as long as the net benefits to society are positive, the decision to encourage formalization is socially desirable. In this view, determination of the winners and losers in formalization process becomes very necessary. If it is ascertained that we have more winners than losers for instance, then mechanisms could be found to make the winners compensate the losers. These mechanisms do

not have to entail explicit transfer of funds but can be built into the reform package itself (through taxation and other reform variables for example). We need to interrogate the current micro enterprise policies in Nigeria to empirically ascertain whether this in-built mechanism exists, if not, provide policy recommendations for their inclusion in our micro enterprise policy milieu

4.0 Model Specification and Methodology

An entrepreneur chooses to be in the informal sector because

$$V_p(\text{informal}) > V_p(\text{Formal without reforms}) \dots\dots\dots(1)$$

Where V_p is the discounted stream of profits over the life of the firm, V_p (informal) is the private (as opposed to the social) value of the firm under continued informality, and V_p (formality without reform) is the private value of the same firm, also expressed in net present value, under assumption that the firm is formalized into the existing legal and regulatory framework.

Three factors can make the private value of a firm higher under informality than under formality. The first is the high relative cost of entry (obtaining and renewing a license); operations (paying social insurance, corporate taxes, and value-added taxes, and enduring inspection of factory and products); and exit (costly procedures for liquidation or bankruptcy) in the formal sector. The second is the expectation of low benefits from shifting to the formal sector under the current regulatory environment, especially with respect to obtaining credit from the financial sector at reasonable rates, gaining access to efficient infrastructure, and having contracts fairly and efficiently enforced. The third is that entrepreneurs in the informal sector are able to develop extra-legal (albeit suboptimal) practices to protect their property rights, make informal contracts, and avoid payment of stiff penalties.

The question then is what it would take to make entrepreneurs change their mind and move to the formal sector. The answer depends on whether or not the government adopts sufficient reforms to reverse the inequality in equation 1, more specifically, if government adopts reforms such that:

$$V_p(\text{informal with reforms}) > V_p(\text{formal}) \quad (2)$$

Entrepreneurs in the informal sector will freely shift to the formal sector if the right reforms in the formal sector exist. However, partial reforms of the regulatory regime governing entry, operations, or exit may not be sufficient to make it attractive for entrepreneurs to formalize. Partial

reforms are desirable in their own right, but they will not be effective unless they collectively satisfy the inequality in equation 2.

So far the formalization decision has been discussed from the perspective of individual entrepreneurs. From Society's perspective, the decision is more complicated. It depends on the likely impact of formalization on key economic agents, namely, entrepreneurs, workers, consumers and the government. *Reforms will be socially desirable if the social value of the firm in the formal sector is greater than that in the informal sector*

$$V_s (\text{ formal}) - V_s (\text{ informal}) > 0 \quad (3)$$

Where V_s is the discounted stream of benefits (loses) to all economic agents affected by the operation of the firm.

3.2.1 Estimating Welfare Impacts of Formalization.

The change in welfare (W) is the difference between the two values. This change in welfare, also expressed in net present value, can be decomposed into its recipients as follows:

$$W = V_s (\text{ Formal}) - V_s (\text{ informal}) = \Delta P + \Delta L + \Delta C \quad (4)$$

Where ΔP , or change in profits, represents the shares of entrepreneurs and government in W (divided among them on the basis of the taxation regime); ΔL represents the change in the shares of workers; and ΔC represents the change in shares of consumers. Without formalization reforms, the change in welfare may not justify formalization socially, and the arguments for "leaving the informal sector alone" will hold. With appropriate social reforms, the social value of the firm can be increased enough to justify formalization.

In principle, the two social values are not expected to be equal if a package of formalization reform is adopted. On the one hand, formalization would lead to the expansion of firms, higher productivity, and a realignment of prices, including selling prices, interest rates, and wages. On the other hand, it would entail some expenditure of real resources to cover the cost of creating a new organization to handle the formalization process, maintaining books for tax purposes, and enforcing contracts. On balance, and without taking into account any general equilibrium effects, the net benefits from formalization are expected to outweigh the cost of carrying out the formalization process

Formalization is expected to have different welfare impacts on different groups. Entrepreneurs and the government are likely to be better off. How the expected increase in profits will be divided between the two will depend on the taxation regime for newly formalized firms. Workers are also expected to gain from formalization, through enrolment in social

insurance, higher wages from improved productivity, and new employment opportunities due to expansion (these gains may be partially offset by lower take home pay)

The impact of formalization on consumers has to be determined. It depends on the price they paid for the product in the informal sector, the price they have to pay after formalization, and the incidence of the value-added tax. The difference between the relative prices of the products in both formalized and informal sectors will determine whether they are better off or worse off. Added to the incidence of value-added tax they have to pay as a result of deepened formalization of many firms.

However, the distribution of the welfare gains is not even across groups. But the sum of the welfare gains (losses) originating from the improvement (deterioration) in firm performance should be equal to the sum of the benefits (losses) that accrued to (or are incurred by) different economic agents. Note that not all the gains from formalization are pure gains to society. For example, while improved productivity is a real saving scarce resources, payments of taxes is a mere transfer from entrepreneurs or consumers to the government. That is not to say that transfers are not important; they involve important redistribution among different actors in society. The point is that transfers are netted out in our calculation of the welfare impact of formalization.

In order to capture our stated objectives, we develop a simulation game carried out in five steps.

Step 1.

This step involves estimating the value of a “typical firm” in the informal sector under the assumption that it would continue to operate extra legally. In order to accomplish this task projections will be made of all revenues, costs (including extra legal costs), and profits. The information about the typical firm in the informal sector will be obtained from a field survey of selected informal firms using a questionnaire instrument. Projections will be needed because the benefits and costs of the investment or formalization decision occur over time and need to be discounted.

Step 2.

The second step involves estimating the value of the “typical firm” under the assumption that it will be formalized into the current legal and regulatory framework. Under this scenario the firm no longer bears cost of extra legality but is obliged to pay the cost of entry, operation, and exit associated with being formal. The two sets of cost estimates will be derived from a careful analysis of existing rules and regulations, interviews with firms in the formal and informal sectors, and interviews with lawyers and accountants familiar with the current business environment in Nigeria.

By comparing the values of a firm under continued informality and under formalization under the current regulatory regime and institutional reform environment, it is possible to estimate the behavior of firms that operate informally.

Step 3

The third step involves estimating the third value of the firm with the assumption that it will be formalized into a reformed regulatory environment with further assumptions of policy and institutional reforms. A tentative balance sheet of each firm is constructed, and assumption built into it to capture the true value of the firm now and in the future. These modifications in the assumptions about regulatory and institutional reforms are translated into an increase or decrease in revenues, a reduction or increase in cost, or a redistribution of resources among different groups. A conservative approach will be adopted to avoid inflating the impact of formalization. For example, it will be assumed that the firm will expand by just 4 percent a year during the first five years, growing at 6 percent a year thereafter. These growth rates do not involve large jumps and are in line with the potential growth rate in Nigeria. Similarly, it will be assumed that productivity will improve by just 1 percent a year, given the severe constraints informal firms currently face in Nigeria. It will also be assumed that selling prices will be equal to that obtained in the formal sector, although overall prices could decline because of declining trends in head-line inflation in Nigeria currently. Finally, wages will be assumed to rise up to minimum wage levels in Nigeria which is currently put at about 30 percent annually, but workers will be expected to accept 10 percent cut in take-home pay as a result contributory pension schemes (as a social benefits scheme). These assumptions suggest that the welfare impact of formalization will represent a lower bound and that actual welfare gains could be larger.

Step 4.

The fourth step involves aggregating the sample firm level data in order to estimate the welfare impact of formalization of the entire informal sector on the economy. This will be achieved by multiplying the values obtained at the firm level with the samples used for the study and then with the estimated number of informal sector firms in the whole economy. We assume that it will take at least five years to complete the formalization process. To simplify the exposition and normalize the results, all values are expressed in relation to GDP (adjusted by the value added tax of formalized firms)

Step 5.

The fifth and final step will be sensitivity analysis, performed under two sets of assumptions. Under the first (optimistic) scenario, more favorable assumptions will be made about the rate at which formalized firms would expand, the rate at which productivity will improve, and the income tax

rate at which revenue would be enhanced. Under the second (pessimistic) scenario, more conservative assumptions will be made for all of these variables. A comparison is therefore made between the two scenarios and policy conclusions drawn from the obtained results.

4. 1 Scope and Data Requirements.

This study on Microenterprise institutional reforms and formalization performance in Nigeria will cover between 2013 and 2018 during which period several micro enterprise institutional reforms in Nigeria were launched.

The main source of data for this study will be largely primary through questionnaire design and administration to a representative sample of informal and formal businesses in the six geopolitical zones of the Nigeria. A representative sample of 200 both formal and informal firms will be randomly selected in the six geopolitical zones and questionnaire designed, incorporating necessary information regarding the different operational characteristics of informal and formal sector firms. Assumptions regarding different states of the world in terms of policy and institutional reforms and their impact between formalized and informal firms will be made to aid the achievement of our objectives.

Additional information will be obtained from the collaborative work on the Nigerian informal sector by both Central Bank of Nigeria and the National Bureau of Statistics. This work will provide information on the current size of the informal sector in Nigeria and other important facts regarding the characteristics and operations of the sector.

5. Dissemination

The findings of the study will be disseminated through several outlets. These include the Development Bank of Nigeria, seminars, policy workshops, conferences and publications in scholarly journals. Also, a sensitisation workshop will be organised for institutions concerned with micro enterprise policy reforms in Nigeria such as the CBN research department, Small and Medium Enterprise Development Agency (SMEDAN), Federal Ministry of Commerce and Industry (FMCI) and Microfinance Institutions in Nigeria.

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