

# INTEGRATING THE INFORMAL ECONOMY

Integrating the informal economy through financial inclusion and the provision of legal, safe and well-equipped locations

Accra, Kampala & Mutare

## 1. PROBLEM DEFINITION

**Financial exclusion and the lack of legal, safe, and well-equipped locations as two main barriers to formalizing businesses.** The informal sector<sup>1</sup> remains the major source of employment across sub-saharan Africa, representing more than 66% of total employment according to the International Labour Organisation (2020). Informality is a multi-layered phenomenon. This challenge will focus on two drivers that affect informality: financial exclusion and the lack of legal and well-equipped locations such as vending stations or public markets. Both are crucial barriers to formalising businesses.

Financial exclusion: Financial institutions often place several restrictions that exclude informal sector workers and businesses, being unwilling or unable to serve the most vulnerable segments of the sub-saharan African population (Kuada, 2019). As the 2010 G20 Seoul summit acknowledged, access to formal financial services is one of the key issues to solve in the development agenda (Zins and Weill, 2016). Financial exclusion means that a person or business, among other things, does not have access to a formal bank account or loan. The lack of formal financial accessibility creates negative consequences, like barriers to saving and borrowing money, or acquiring a contract insurance in

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<sup>1</sup> The informal economy is the diversified set of economic activities, enterprises, jobs, and workers that are not regulated or protected by the state. The concept originally applied to self-employment in small unregistered enterprises. It has been expanded to include wage employment in unprotected jobs (WIEGO).

the regular financial market (Zins and Weill, 2016). As a consequence, informal sector companies end up resorting almost exclusively to informal, short-term funding at high interest rates (AfDB, 2013). This produces poverty traps and hinders their economic development (Demirgüç-Kunt and Klapper, 2012).

**Lack of legal, safe, and well-equipped locations:** For informal workers and firms location and accessibility to customers is a crucial aspect of their business. Indeed, being close to population centers is essential (Kathage, 2018). In the city of Kampala, for example, the informal sector remains concentrated in three locations close to the central business districts with easy access to consumers (World Bank, 2017). The city of Mutare has worked to identify several problems in connection with the lack of viable locations for their markets: informal vendors suffer from a lack of proper roads, storage facilities, factory shells, proper sheds, etc. These two examples show that it is necessary to provide vendors with viable, safe locations close to where the demand is highest. As the World Bank (2017) pointed out, businesses with permanent and legal establishments have better outcomes and are more probable to formalise.

## **2. WHEN AND WHERE DOES IT OCCUR?**

Economic informality is a historical problem. Data on economic informality in Sub-Saharan Africa goes back to the '80s, and since then, total informal sector employment has grown exponentially according to the International Labour Organisation (2020). The informal sector is particularly dynamic in creating jobs and adding value, representing about 55% of the GDP in sub-Saharan Africa according to UNDP (2015). The phenomenon of economic informality affects both rural and urban areas. However, economic informality is a critical component of informal settlements and slums, in which the majority of the informal sector operates. For this reason, it is not a surprise that economic informality is based within the informal settlements. In fact, the data shows that informal firms are mainly based in households (World Bank, 2017).

## **4. WHO IS IMPACTED BY THE PROBLEM? WHAT ARE THEIR NEEDS?**

Regarding the barrier of financial exclusion, most informal businesses are self-funded, while only a few are supported by family members and obtain funding from micro financial institutions (Mothobi, Gillwald and Aguera, 2017). Access to the formal financial sector by the informal firms is minimal. Women and youth workers are particularly vulnerable to financial exclusion due to their “lack of credit history or bad credit history by the owner, inadequate collateral, a lack of skills and the knowledge to produce financial statements” (Mthobi, Gillwald and Aguera, 2020: 3).

Regarding the lack of well-equipped locations, the main population affected are the street vendors and household sellers that are selling products like food, utensils or clothes. Without a legal and safe place to sell their products, informal vendors are more vulnerable and have less incentive to formalise their businesses. Additionally, informal commerce needs to operate close to customers and near high foot traffic, therefore locating them outside of the city center is not a solution (World Bank, 2017).

## **4. ROOT CAUSES**

- ▶ Time and costs required for business formalisation keeps people in the informal sector.
- ▶ Lack of formal employment opportunities perpetuates informality which constrains city resources and economic growth.
- ▶ Lack of data on the informal economy by the government fosters an environment in which informality can thrive.

**Regarding financial exclusion:**

- ▶ Informal workers do not normally have a basic formal education and have low levels of literacy and numeracy.
- ▶ Informal workers' lack of skills and understanding of financial products and how to produce financial statements. Lack of basic financial training.
- ▶ The extended use of cash instead of digital transactions as a tradition.
- ▶ Lack of credit history and/or bad credit history by the informal sector firm owner.
- ▶ Lack of digital devices and access to good quality internet.
- ▶ Access to formal financial services by the informal sector is hampered by the size of the firms (according to the World Bank, 70% of the informal sector is formed of microfirms) with little perceived benefits.
- ▶ Upfront costs of formalisation and cumbersome regularisation process due to an excessive and insufficient bureaucracy.

**Regarding the lack of well-equipped locations:**

- ▶ The majority of the informal businesses need to sell their products to customers within a 30-minute walk and there is a lack of a multi-modal approach towards the provision of proper infrastructure and a lack of political will to make these resources available. Lack of proper roads, storage facilities, and sheds.
- ▶ Lack of land near the customers to provide a market that can accommodate the informal vendors.

## **5. WHY THE PROBLEM HAS THIS NOT BEEN SOLVED YET**

Access to formal financial services by the informal sector is hampered by the size of the firms (according to World Bank, 70% of the informal sector is formed of microfirms), and informal firms often suffer from “lack of credit history or bad credit history by the owner, inadequate collateral, a lack of skills and the knowledge to produce financial statements” (Mthobi, Gillwald and Aguera, 2020: 3). Furthermore, there is a mismatch between the traditional financial systems and the cash-based informal sector.

Regarding the lack of well-equipped locations, the problem is occurring because the majority of the informal businesses need to sell their products to customers within a 30-minute walk (World Bank, 2017), meanwhile there is not enough land or market infrastructure for the high number of informal firms in the adequate places. The mismatch between the demand for markets close to consumers and the lack of that kind of infrastructure has not received enough attention from policymakers. Traditional policy solutions have been to prohibit street vending or to relocate them outside of the city center. Neither approach has offered a solution, as they punish informal workers without offering alternatives (World Bank, 2017).

## **6. CALL FOR ACTION**

The informal economy represents 66% of total employment (International Labour Organisation, 2020), and cities need to find innovative strategies to help informal sector workers and businesses escape from poverty and allow the cities to continue positive and equitable economic development. Two of the main barriers inhibiting the transformation of the informal sector are financial exclusion and the lack of regulated, controlled, and safe work environments and markets. Financial institutions often have internal policies that place restrictions on engaging the informal sector and that exclude informal sector workers and businesses from critical wealth-building financial instruments like

loans and insurance. This exclusion reinforces cycles of poverty and hinders sustainable and equitable economic development in cities. The inability to access financial institutions forces informal workers and businesses to rely almost exclusively on very risky, informal, short-term funding at high interest rates. Likewise, without regulated, controlled, and safe work environments and markets to produce and sell their products, informal vendors are more vulnerable and have fewer opportunities to formalise their businesses. The main population affected by these problems are street vendors and cottage industries that sell goods like prepared food, household items, or clothes and provide services like childcare, elderly care, or house cleaning. Due to their need to operate close to their customers and near high foot traffic, these workers and businesses must be located within the city.

In this multi-city challenge we want the public to share innovative ideas about:

- ▶ How local authorities can build or provide them access to legal, safe, and appropriate work environments that support their businesses.
- ▶ Alternative systems for informal sector workers and companies to access new capital and financial services.
- ▶ Data sharing strategies to allow local authorities to get more data about the situation on the ground to better map, measure, and understand the informal sector and the problems it faces.
- ▶ Successful, innovative, and sustainable solutions from other places in the world to support the informal economy and its workers in the participating cities.

## 7. THE SOCIAL IMPACT OF YOUR IDEAS

The solid waste management in African cities is a wicked problem in the sense that it is interdependent, complex, systemic and urgent. The public sector cannot solve the problem on its own and, in this sense, gathering ideas from the public is key. On the one hand, engaging the stakeholders brings the best collective intelligence from the community into the policy-making process. On the other hand, better solutions tend to be produced when those receiving the interventions are involved in designing them. If implemented well, community-led responses can help in finding cost-effective solutions to reduce financial exclusion and identify the best places to give informal businesses the proper infrastructure for their own development, encouraging them to formalise their activity.

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