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Summary of
Urban Informal Sector Investment Climate Analysis in Kenya

Informal employment contributes approximately 34% GNP in Kenya, and is increasing more than ten fold the growth rate of the formal economy at just over 16%. This statistic clearly has several implications for Kenya's private sector. Informal enterprises are able to circumvent government regulation and avoid mandatory taxes and fees, yet they risk being punished if detected and often have restricted access to services.

This note summarizes the paper "Kenya: Urban Informal Sector Investment Climate Analysis". The paper draws on the Investment Climate Surveys undertaken in Kenya in 2003 on formal manufacturing and in 2004 on the urban informal sector in order to analyze the determinants of firm's decision to be formal.

Productivity Trends in Kenya's Private Sector

The recent empirical analysis of Kenyan firm's productivity highlights the productivity trends and differences between informal (micro-level, non-registered) and partially formal (micro level, registered) firms. Top performing partially formal garment firms are growing their sales, taken to be a proxy for productivity, and outperforming the top performers of the informal economy; however, in general the partially formal firms surveyed are performing worse than (or equal) to their informal counterparts.

One of the important distinguishing factors in understanding this trend is to look at distinct groupings within the informal economy and recognize the important role of linkages to the formal economy. Those stellar performances by informal firms may be evidence of ***forward links*** that the more entrepreneurial firms have established with the formal economy. In fact, selling to small businesses has a significant impact on firm sales both for informal firms and partially formal firms. This in turn impacts the prospects for growth of the firm and can signify that these firms are capable, and ready, to formalize their business.

Having a labor force with a sufficient level of education and technical know how is of the utmost importance for any sector looking to grow. The size of a firm, or the fact that it is or is not registered does not alter the need for an educated workforce. Understanding how the informal and partially informal sectors compare with the formal sector here can be informative. The data collected by the recent surveys clearly shows that the formal and partially formal respectively has a higher percentage of its workforce with at least secondary school education than partially formal and informal firms. What is most striking about the data is that on average a higher percentage of partially formal firm's workforce has post-secondary school education than a formal firm's workforce. The key to understanding this unexpected trend is the role of ***apprenticeships*** which due to their formalized nature are often categorized as post secondary education—Kenya has one of the more developed formal training systems in the region, and these programs tend to be engaged in the informal sector. The obvious ensuing question would be to ask why this is the case. Another possible explanation is to look at the difference in relative rather than absolute terms—the micro-sector (including informal and partially formal firms) tends to consist of much smaller firms, and thus may by its very nature have a higher percentage of their workforce with higher levels of education.

Most crucially, the data found that over time, informal firms tend to fail quicker than formal firms, and a lot of them exit the sector or of course, graduate to partial or full formal status, within a couple of years—formal firms average near 30 years of age, partially formal firms are approx

* Between 1991 and 1994 the informal economy grew by 16.1%, compared with the formal economy, which only grew at 1.6% during that period.

half of that, while informal firms are about a third as old as formal firms.

Different Perceptions of Key Constraints to Enterprise Growth

Partially formal firms consistently rate each obstacle as a greater impediment to business than do informal firms, with the exception of infrastructure and access to land. Informal firms have two main concerns: they perceive finance and infrastructure as their main concerns—partially formal firms are also seriously concerned by those constraints, but also rate economic policy uncertainty and customs/trade regulations in their top five. Formal firms only share the cost of finance as a top concern.

By breaking down these constraints into benefits and constraints to formalization we can understand these different perceptions and how they play out in a firm's decision to formalize, becoming closer to identifying types of interventions for increasing formalization in Kenya.

Benefits to formalization

Finance. Access to and cost of finance were ranked as a "major" or "very severe" constraint by more firms than any other obstacle to business, and this perception has close links with formality. Looking at the usage of finance by the formal, partially so and informal sectors can clarify the texture of this constraint. Less than 20 percent of informal firms and nearly 30 percent of partially formal firms have ever had a loan, tending to rely on internal funds or familial ties—when asked whether they had ever applied for a loan, over 50 percent of formal firms responded positively, and 30 percent fewer have had to rely on internal funding alone. This detail along side a more severe perception of access to credit as a binding constraint to informal firms, suggests that banks do not grant loans to non formal firms as frequently.

Land Access. The full sample of formal firms and more significantly grouped with them over 95 percent of partially formal firms occupy both their land and buildings. Looked at in relation to informal firms one can see huge divergence—only 70 of these firms responded positively, and this itself may be inflated since many informal enterprises are home-based. If the informal firm is growing it will eventually need its own space, but one would expect that it is then harder to remain informal in the eyes of Government. Firms will only register if the benefits outweigh the costs, thus land occupation must lead to expanded profits that outweigh registration costs for a firm to choose to occupy land.

Crucially, the occupation of property is necessary to obtain infrastructure services. This is supported by the evidence that a lower percentage of firms that occupy land view infrastructure issues as binding constraints.

Infrastructure. The third benefit to formalization, and closely affiliated to access to land. It is therefore not surprising that informal firms feel infrastructure concerns more acutely than others; 90 percent perceive both telephone and transportation as binding constraints to growth and productivity, while less than 50 percent of formal firms felt severely constrained.

Objective data reinforces the suffering of informal firms and provides a good example of the benefits of formalization. Formal firms lose approximately 9.5 percent of sales value as a result of power supply interventions, already a high value compared to the average in sub-Saharan Africa (6.1% 2004). But this is less than a third of what even partially formal firms have to endure. Alternative power supplies would provide some sort of mitigation for firms, but given the outlays and apparent restricted access to financing, this becomes somewhat of a cyclical dilemma for informal firms—it is not surprising that whereas approximately 70 percent of formal firms own a generator, only 5 percent of partially formal firms own their own and a mere 3 percent of informal firms.

Business – Government Relations. It is self-evident that informal firms, as they interact less with government, tend not to have high expectation of government services and thus rate this as much a constraint. However, formal firms do pay taxes and thus are more likely to expect services that are available and efficient, hence the higher percentage of unsatisfactory responses—over 70 percent. The important point for policy makers to notice here is that poor Government services will serve only to reduce the benefit to formalization and thus decrease the likelihood that informal or partially formal firms will make the decision to formalize.

Business-Government relations presents another interesting story. Ten percent more informal firms perceive regulations to be inconsistent than partially formal or formal firms. Here at least it would seem that formal firms are reaping the benefit of formality. It is not surprising that government officials feel less of a need to be consistent in their interaction with informal firms, who have less entitlement and thus inclination to complaint.

Costs of Formalization

Taxes. An obvious cost to formalization is the obligation to pay taxes, involving both pecuniary and administrative headache for firms. This is reflected in the significant difference in perception of taxes, shown in the graph below.

As expected, the data shows a clear correlation between formality and percentage of sales reported for tax purposes. On average, formal firms report nearly 90 percent of their sales, whereas partially formal firms report closer to 55 percent, with informal firms reporting just 17 percent. Becoming formal would therefore have to overcome the real benefits of tax avoidance.

Corruption. Formal firms perceive corruption to be more of a concern for growth than any other constraint. Objective data on informal payments to government clarifies this relationship—the informal firm has to pay more payments to government on average, which can be classed as the price they pay for government services. However, since it is not registered it pays fewer taxes than the formal firm. Therefore it is not surprising that the formal firm begrudges informal payments more, since they are effectively being *double charged*.

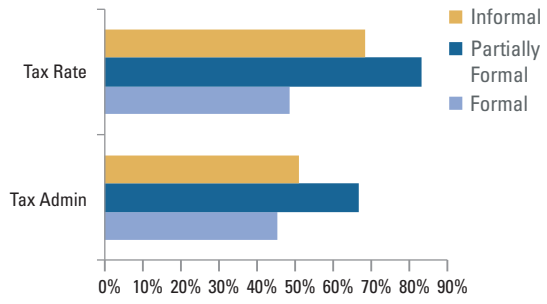
Other costs. Not to mention the one-time cost of registration, which according to the World Bank Group's *Doing Business* data is significant in Kenya, ranking 93 of 155 countries surveyed, the regulatory costs of formalizing can be significant, especially if the government collects past taxes. Informal firms do not bear the cost of regulations associated with labor, customs, safety, consumer protection or other regulations which can be significant.

Conclusion and Policy Suggestions

A large informal sector has implications both for the firm and Government. Increasing the formal economy provides a wider tax base, and thus theoretically at least allows lower taxes and increased public services; a complete picture of the economy and hence more informed decisions; and the application of measured regulation that benefits the public good. Formalization also means less wasted entrepreneurial spirit, since a firm's untitled assets cannot be used as collateral to start or expand a firm, and so the business stays small and underproductive. Moreover, a low income means that there is no capital to formalize.

Punishing informal firms has proved to have no positive effect on the firm's decision to formalize—raising their costs just increases prices in the formal sector and decreases overall employment.

Figure 1. Percentage of firms perceiving taxes to be a "major" or "very severe obstacle to operations and growth



However, there are several policy options for the public sector to motivate increased formalization, with differing weight on beneficiaries:

- *Improve recurring formal productivity factors* including a strong financial system, quality physical infrastructure, and available land—*formal firms benefit*
- *Reduce Recurring formal Costs* such as taxes, corruption and regulations, both in terms of processes and fees—*formal and informal firms benefit*
- *Reduce One-time Costs* since registration represents the most visible barrier to formalization. Reducing the complexity and fee will lower this barrier—informal firms benefit
- *Improve Recurring Informal Productivity Factors*; providing services to informal firms directly would positive social implications for the poorest in Kenya, and may allow firms to expand, or at a minimum increase their productivity and income, but is a near time solution since it directly rewards informality and increases competition for formal firms.—informal firms benefit
- *Improve the Stability of the Investment climate* through good Governance and consistent policies so that firms feel able to make long term decisions. If experience tells a firm that Government is reliable, they may form expectations of a positive return in the future and thus are more willing to formalise.—Formal and informal firms benefit

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This note is part of a series of summaries of analytical work of the Africa Private Sector Development Unit. It is based on the report "*Kenya: Urban Informal Sector Investment Climate Analysis*". For more information, visit the website www.worldbank.org/afr/aft