

# TRADE REFORMS, INFORMAL SECTOR ACTIVITY AND EMPLOYMENT

*[Some Preliminary Thoughts]*

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*A Research Discussion Paper prepared for the joint WTO-ILO Workshop on Global Trade and Employment, 31 August – 1 September, 2009, Geneva, Switzerland.*

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## INTRODUCTION

Following the wave of political independence that swept across the developing world (including most of sub-Saharan Africa) in the early 1960s, there was an accompanying conscious effort at promoting economic independence. This led to widespread adoption of an inward oriented development strategy which placed emphasis on the imposition of tariff barriers (TBs) and non-tariff barriers (NTBs) to grow domestic infant industries. This strategy failed woefully as the observable lack of growth and slow pace of economic development over the decade of the 80s and 90s has been largely attributed to lack of openness in these economies (Krueger, 1978; Krueger and Tuncer, 1982; Bhagwati, 1988; Dollar, 1992). The policy response to these findings marked the beginnings of the shift in emphasis from protectionism to openness and trade liberation as a means of promoting growth and development.

The error of fallacy of composition notwithstanding, the success of the Asian tigers became the reference point for the pursuit of an outward-looking trade aided development strategy which judging by the performance of most of these economies over the last three to four decades has not fared too well either. Efforts at promoting growth trade and development has witnessed the emergence of bilateral and multilateral trade agreements aimed at promoting intra-regional trade as well as north-south trade. Illustrative of the former is the rise of regional and sub-regional economic integration movements (Olofin et.al 2008) while in relation to the latter focus has been on the series of EU-ACP arrangements under the LOME conventions and their more recent transformations into development partnership arrangements. Similarly the US sponsored AGOA arrangement has been aimed at promoting growth and employment opportunities for African countries. We hypothesis in these preliminary thoughts that there is a major missing link in all these efforts without which the story in sub-Saharan Africa is not likely to witness any significant change except it is given the attention it deserves. This is the challenge of mainstreaming the informal sectors in these economies in the promotion of growth, trade and employment.

Generally, virtually all sub-Saharan African countries are characterised by a form of rural-urban dichotomy. The rural areas often lack basic socio-economic infrastructure such as good roads, water, and electricity. These facilities are usually concentrated in urban centres, and hence industries and factories are clustered around urban centres. This has often led to large rural-urban migration. Similarly, the economies evolve and operate in formal-informal sector divide. The formal sector comprises of public sector and large private sector firms and industries whose operations are covered by existing product and factor markets' regulations. The informal sector on the other hand, is made up of small-scale firms and business enterprises that either do not comply at all, or only partially with existing markets regulations (see Scherer, 1980; Ajakaiye and Akerele, 1996; Goldberg and Pavcnik, 2003; Folawewo, 2004; Olofin and Folawewo, 2006)<sup>1</sup>. Over the years,

the informal sector has continued to play a prominent role in these economies by way of income and employment generation activities. It is estimated that in Sub-Saharan Africa, as much as over 50 per cent of the entire workforce is employed in the informal sector (Vandemoortele, 1991, Abumere et al, 1998).

The slow pace of development, which has manifested in sluggish growth, poor industrial development and persistent high rate of unemployment, coupled with the economic crises of the early 1980s and political instability in a significant number of African states has led to the expansion of the informal sector in the region over the years. Incidentally, the adoption of more vigorous outward trade orientation policies by these states has not resulted into the much touted gains from trade. Conversely, the informal sector activities have been booming with more employment being recorded in the sector. This scenario has led to the questioning of the impact of trade policy on the informal sector.

In this short paper, informal sector is defined to include the privately owned small and medium-scale enterprises that are officially registered to undertake business activities, (Olofin & Folawewo, 2005). However, these enterprises only operate under limited official regulations that only cover their operations permit, business names and premises registration, but do not cover their internal operations. That is, enterprises that are operating under official regulations that do not compel rendition of official returns on their operations or production process. Furthermore, these enterprises engage mostly in the production of services, have low capital requirements and are relatively labour intensive, and they have wage employment characterised by low wages.

As much as it is widely acknowledged that the informal sector plays an important role in the process of economic development in most developing countries including sub-Saharan African countries, the informal sector continues to receive less than the attention it deserves in empirical studies. The bulk of empirical econometric work in these economies focus on macro studies of the formal sector, for which published secondary data is often available the varying quality of such data notwithstanding. Very little attempt is made at analysing the informal sector for which there is hardly any published data, and for which the collection of primary data is often an arduous highly demanding expensive task left to the researcher. There is need to confront the rigour and challenges of collecting primary data to aid our understanding of the nature and functioning of the informal sector in African economies. Such refocusing of attention in empirical studies is necessary and crucial to the mainstreaming of the informal sector into the development process. Trying to fill this important analytical gap has been the primary focus of our ongoing research effort, albeit currently limited in scope to the Nigerian economy due to resource constraints. Our empirical investigations are aimed at understanding the nature and structure of the informal sector with particular focus among others on the following, (Olofin & Folawewo, 2005, 2006):

- empirical examination of the determinants of labour demand,
- the nature of workers' skills in the urban informal sector
- The nature of firm-specific factors, such as, year of establishment, ownership structure, investment and profit levels as important factors affecting the demand for labour in the informal sector
- The role of wages in the determination of labour demand.
- Measurement of workers' productivity (measured by educational level) and experience as an important explanatory factor in determining level of employees' earnings in this sector.

Our studies have for reason of resource constraints been limited to Nigeria. While we expect some degree of similarity to exist in the nature, structure and workings of the informal sector across most African countries we do expect to find some country specific features that may make sweeping generalisations based on our findings on Nigeria quite difficult. Our intention therefore is to extend the scope of our coverage in a panel data study that would allow us have a more representative picture cutting across several African countries, by selecting representative countries in the various sub-regional zones. We consider this as critical to our understanding the nature and role of the informal sector in the development effort in Africa and with specific reference to trade and employment generation.

It is worth noting that in the Doha Round negotiations, majority of sub-Saharan African countries are classified as Least Developed Countries (LDCs) that lack the capacity to trade. This suggests that most of these countries are not required to assume strongly binding commitments in trade agreement. As a result, most of the countries are under the trade assistance programme known as the Integrated Framework (IF) and the Enhanced Integrated Framework (EIF) that provide support for LDCs to enable them grow to trade. Consequently, the incidence of formal trade among these countries is low; while informal trade is high.

It is our considered view that any re-assessment of the current global trade architecture would be incomplete if research attention is not focussed on the challenges of trade and employment in the informal sector in these economies. There is the need to unravel the link between trade liberalisation and informal sector employment activities in sub-Saharan African economies. This becomes more so when it is noted that most empirical studies on trade and employment often focus unduly on the formal sector, with particular attention on the manufacturing sector (see WTO-ILO, 2007), while only scanty attention is given to trying to examine the link between trade and informal sector activities, such as in Carr and Chen (2002), Goldberg and Pavcnik (2003), Marjit and Maiti (2005), Soares (2005), Kapoor (2005), and Marjit and Kar (2007).

## **II. SUGGESTIONS FOR LIKELY RESEARCH FOCUS AND EMPHASIS**

The broad objective of such studies could be that of aiming at evaluation of the impact of trade liberalisation on informal sector employment activities at the micro levels before embarking on global analysis of impact at the broad aggregative macro levels as is often the case in most formal sector studies. More specifically in the analysis of informal sector activities attention may focused on:

- examining the structure and diversity of informal sector activities;
- evaluating the impact of ‘aid for trade’ programmes on informal sector activities;
- The extent to which trade assistance programmes have enabled the LDCs in the region to grow to trade?
- If yes, quantifying the magnitude of such impact first on the informal sector, and then on the economy as a whole and examining the corresponding aggregation problems.

## **III. JUSTIFYING THE RE-FOCUSING OF EMPHASIS**

The need for this re-orientation of emphasis from the formal to informal sector studies is dictated by the need to recognise the significance of the informal sector in the development process and with particular reference to trade and employment generation. The undue emphasis on formal sector activities appears not to have resulted in any significant changes over the decades regardless of the development strategy or strategies that have been adopted. It is also worthy of note that the informal sector in most cases bears the brunt of any negative fall outs from badly formulated and/or badly implemented macroeconomic policies designed primarily for the formal sector. For these reasons, the study of the informal sector is considered crucial to understanding the relationship between trade, growth and employment generation in these countries. The few exceptional studies in this regard have been undertaken in Latin America and Asia. For example, Goldberg and Pavcnik (2003) examined the response of informal sector in Brazil and Colombia, Soares (2005) focused on trade and informal sector dynamics in Brazil, whilst Marjit and Kar (2007) evaluated the response of informal sector to trade in India. These studies have however, provided little insight into the effects of trade liberalisation in developing African countries, as their findings may not be capable of such generalisation. In addition, existing studies on trade and employment in Africa have been concentrated largely on the formal sector (e.g. see Adewuyi, 2005; Adewuyi and Adeoye, 2008), with the exception of Currie and Harrison (1997).

It is equally worthy of note that results from analysis of the relationship between trade, formal and informal sector employment activities remain inconclusive as findings from such studies have sometimes been contested on methodological grounds. There is therefore considerable

room for more research effort being devoted to examining the nature and implications of this nexus if and where it exists.

#### **IV. SOME THEORETICAL PROPOSITIONS AWAITING FURTHER EMPIRICAL VERIFICATION**

The literature is replete with several theoretical propositions regarding possible outcomes in seeking to understand the relationship between trade and employment. Some of these for which additional studies would yield greater insights include:

- that trade liberalisation could have both positive and negative effects on employment in terms of job creation and job destruction;
- that in the long run trade is expected to increase inequality between capital and labour or between skilled and unskilled labour in developed countries, while the gap is expected to narrow in developing countries;
- the effect of trade on employment in the short run depends on country specific factors, however, in the long run the efficiency gains caused by trade liberalisation are expected to lead to positive employment effects, either in terms of quantity or quality of job creation or a combination of both;
- exporting sectors of an economy are expected to expand and demand for more labour, while importing sectors would contract and lay-off workers;
- trade policy can have effect on employment if an economy is not characterised by full employment before the reform, or if some domestic policies and labour market characteristics hamper the adjustment process (Brecher, 1974);
- effects of trade on employment to a large extent depends on the link between export – import firms, low-productivity and high productivity firms among others (Bernard and Jensen, 1999; Bernard et al, 2007); and
- trade reforms are expected to depress informal wage by contracting the formal sector and driving labour into its informal counterparts ( Marjit and Kar, 2007).

Empirical evidences have emerged in respect of some of the foregoing propositions, but hardly can such evidence be taken as sufficiently conclusive as to warrant the exclusion of the need for further research. This is especially true in the case of developing African economies where the challenges of job creation and poverty alleviation in the informal sector remain as major constraints to overall development effort.

## **V. SOME MAJOR EMPIRICAL FINDINGS DESERVING OF FURTHER EVIDENCE**

Some major empirical findings deserving further evidence particularly from the context of developing countries such as sub-Saharan African economies include the following:

- there have been some positive effect of trade on manufacturing sector employment (Papageorgiou et al, 1990; WTO-ILO, 2007);
- the effect of trade on employment depends on the prevailing job search behaviour and the nature of the labour market in an economy (Rama, 2003);
- trade liberalisation has led to a rise in real wage and real fixed assets in the informal manufacturing sector of India (Marjit and Kar, 2007);
- post-comprehensive trade liberalisation led to a rise in firms' hiring of more temporary workers in Morocco (Currie and Harrison, 1997);
- trade reforms lead to a reallocation from the formal to informal sector in Latin American and Caribbean countries (Stallings and Peres, 2000),
- there is no empirical evidence showing that trade liberalisation contributed to increases in informal sector employment in Brazil and Colombia (Goldberg and Pavcnik, 2003).

## **VI. SOME METHODOLOGICAL AND DATA ISSUES**

Furthermore it is important to note that in addition to theoretical issues and inconclusive empirical results awaiting further evidence, there is also the problem of the complexity of outcomes resulting from yet to be resolved methodological issues and challenges, ( see: Greenaway, 1993; Collier, 1993; Gaston and Trefler, 1997; Trefler, 2001). Some of these methodological issues also need to be addressed with specific reference to informal sector activities, (see:Dollar and Collier, 2001, WTO-ILO 2007). Generally, given the nature of the complexity of the informal sector, an eclectic investigative approach may be more promising than a doctrinaire conventional approach to modelling which more often than not is adopted in studying the formal sector, ( see: Shapiro and Stiglitz (1984); Bulow and Summers (1986),;Saint-Paul (1996) and Goldger and Pavcnik (2003); Olofin & Folawewo, 2005).

Unlike it is with formal sector studies where easy access to published secondary data reduces the burden on the researcher, the collection of primary data remains a challenging task that must be tackled by the researcher of the informal sector. It is no doubt a highly challenging task, but nonetheless not an insurmountable one. We also see collaborative research effort between institutions in Africa and other developing countries in Asia and Latin America with informal sector challenges helping to resolve some of the data and methodological challenges confronting informal sector research in Africa

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