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Thinking Policy Together

Determinants of the Informal Sector in Kenya

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Introduction

According to the Kenya National Bureau of Statistics (2018) Economic Eurvey, Kenya's informal sector is a dominant player in the labour market, with statistics showing that in 2017, the sector accounted for 83.4 per cent of the new jobs created. This has been the trend in previous years where, cumulatively, the informal sector caters for over 70 per cent of total working population, contributing significantly towards national development in Kenya. The informal sector in Kenya is characterized by limited job security, low productivity, low incomes, unskilled apprentices, low absorption of technology, poor working conditions, unfair competition to formal establishments, prevalence of illicit trade and counterfeits and lack of formal statistics for proper planning purposes. Due to these characteristics, the informal sector despite providing employment to the population is also a cause of the working poor phenomenon, poverty and inequality leading to weak economic growth.

The Government of Kenya acknowledges the challenges presented by the persistence of the informal sector and has worked to develop policies, regulations and institutional frameworks to mitigate the consequences of growing informality. Notable government policies passed include Sessional Paper No. 2 of 2005 on Development of Micro and Small Enterprises for Wealth and Employment Creation for Poverty Reduction; Micro and Small Enterprise Act of 2012 that established the Micro and Small Enterprise Authority for coordination and harmonizing the micro and small enterprises, and the Trade Licensing Act of 2006 that provided registration for business and trade regulation. Despite the interventions by the Government of Kenya, the informal sector continues to be a major player in employment creation and as a source of livelihood albeit with poor standards of living and low productivity. To address the problem of persistence informal sector and improve the sector's performance and contribution, the study analyzed the determinants of informality in Kenya. The study also reviewed four selected countries (Indonesia, Rwanda, South Africa and Brazil) to draw lessons from the analysis being cognizant of the heterogeneity and ambiguity that the informal sector presents.

Key findings

a) Entrepreneur Characteristics

The study identified that Entrepreneur Characteristics (level of education and sex of the owner) were key in determining a firm's operation in different levels of informality. The study found that entrepreneurs with university education were less likely to be in totally informal operation while more likely to operate in total formality. Female-female partners had a higher magnitude of operation in totally informal while at the same time they were less likely to operate in total formality compared to male-only owned enterprises.

b) Establishment Characteristics

These included firm age, size of the firm, ownership type, credit application, sources of financing and sectors. Cumulatively, firms that were in existence for over six years were less likely to operate in total informality, with the highest magnitude for those that were over 21 years. Small and medium establishments were less likely to operate in total informality. Furthermore, the medium establishments had a higher likelihood to operate in total formality. The establishments that applied for credit operated in totally formal spaces in comparison to those that did not apply for credit. Lastly, the establishments that sought financing from family, own funds, friends and Rotating Savings and Credit Associations (ROSCAs) were more likely to operate in total informality spaces.

c) Exit Rationale

In exit rationale, the entrepreneurs with no other alternative as their reason for starting an activity were highly significant and had a negative relationship with operation in total formality compared to those that started their business because of having skills in the activity. In addition, the entrepreneurs that preferred self-employment were less likely to operate in total formality while the magnitude of those that have family having worked in the activity were more likely to start their operation in total informality and less likely to operate in total formality by 3.12 percentage points.

d) Exclusion rationale

The exclusion rational entailed the business constraints. Market factors such as local and foreign competition, lack of markets and shortage of raw materials were significant and positive compared to government regulations. The establishments that experienced the market factors as constraints were more likely to operate in total formality and less likely to be in total informality.

e) Business Environment

Business environment was a significant factor in determining the level of informality. In the analysis, the business environment was proxied by the tenancy risk as securing workspace is a significant part of the establishment's survival. Eviction by owner/landlord for establishments that have rented their premises and expiry of tenancy were both significant compared to eviction by County Governments. Establishments that faced the risk of eviction by owner/landlord were more likely to operate in total informality while those that faced expiry of tenancy were less likely to operate in total informality.

f) Review of Select Countries' Informal Sector Environment

The major lesson that can be drawn from comparator and aspirator countries is that reduction or abolishing registration costs yielded little results on transitioning informal enterprises to formality. In Brazil, however, provision of tax incentives to formalization had a significant effect in transitioning and keeping enterprises in formality.

Policy Recommendations

The policy environment in Kenya needs to be responsive to the challenges facing the informal sector. The objectives of the study established need for enhancement of existing policies, developing new ones and generally putting the informal sector at the centre of development nuance. Considering the findings of the study, the following recommendations are suggested:

1) **Addressing the existing regulatory gaps:** The Government has over the years come up with policies, regulations and institutional frameworks to address the plight of small businesses. Absent in these initiatives is explicit identification of informal establishments in the official documents. Reference to the sector has been ambiguous, ranging from SME, MSEs, MSMEs and "*jua kali*", which do not necessarily mean informal enterprises. Therefore, there is need for a clear definition of the informal sector and its recognition and inclusion in policy and regulatory documents; this will develop targeted focus to the sector. A policy is imperative to define the sector and focus on bringing it from the periphery of the development agenda.

2) **Focus on entrepreneur and establishment characteristics:** Empirical results from the study point to the weight the level of education, sex of the owner(s) and establishment characteristics Isuch as age of the firm, size of the firm and ownership type have as determining factors of informality. The Government has implemented a 100 per cent transition rate policy in education from primary to secondary school, which is commendable. However, there is need to finalize the draft Technical and Vocational Training policy and implement decentralization and equipping of training centres across all counties.

3) **Champion for a policy position on inclusion of female time use in national statistics:** Female-owned establishments were likely to operate in high levels of informality. This has various aspects to it, such as gender norms about traditional female roles which present challenges to women coming out of the shadows of gender stereotypes. Female domestic labour and time use are not recognized as a contribution in official statistics, hence a limitation in addressing their plight. The National Gender Equality Commission (NGEC), an independent commission mandated with gender mainstreaming, should champion a policy position on inclusion of female time use in national statistics. Moreover, NGEC should sensitize, create awareness and seek to introduce gender equality in school curricula to debunk gender stereotyping.

4) **Focus on policy-driven incentives that will induce formalization:** There has been a focus on easing registration through reduction of procedures and harmonizing the processes. Unfortunately, the bureaucracy has been decentralized to counties too where the business environment is limiting. Lessons from reviewed countries indicate that policies meant to reduce entry costs to formality have little to no impact. Therefore, the Government should focus policies on incentives after formalization, such as tax heavens for periods of time, embedding social protection in registration and providing affordable and patient capital that does not require informal establishments to have collateral.

About KIPPRA Policy Briefs

KIPPRA Policy Briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity in the public policy making process in Kenya.

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