

# A NOTE ON THE INFORMAL BUSINESS SECTOR IN NIGERIA

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## *Abstract*

*The study sought to analyze Nigeria's informal sector by assessing factors that drive and inhibit informality; the characteristics and contributions of the informal sector to the economy using survey data obtained from 2010 National Micro Small and Medium scale Enterprises (MSMEs) Survey as well as data from Doing Business. With the use of simple descriptive statistics, it was found that most of MSMEs were in the informal sector with heterogeneous characteristics. It also found that the informal sector contributes 50.07% of MSMEs' contribution to Gross Domestic Product (GDP) and 27% to total GDP. The study found that high cost of enforcing contracts, starting a business and getting infrastructure; high and multiple taxations; macroeconomic instability among many others drive informality. On the other hand, information and enlightenment, provision of infrastructure and enforcement of regulation were found to inhibit informality. On the basis of these, several recommendations were proffered.*

**Keywords:** *Informal Business, MSME, Nigeria.*

## INTRODUCTION

In Nigeria, like in many developing countries, informality is a characteristic that defines a huge percentage of business organizations. This informality is heterogeneous in nature and recent data shows that the accounts for about 57% of Nigeria's rebased GDP according to UN report (Business Day, 2014). The preponderance and importance of the informal sector is an evidence of its critical role in provision of employment (especially for women and other disadvantaged groups) and a virile base for entrepreneurial growth and development. These undoubtedly, help in wealth creation for poverty alleviation.

The size, importance and relevance of the informal sector to sound policy making and implementation creates the need to formalize this sector so as to increase the benefits accruable as a result of formalization. The benefits of formalization include broadening of the tax base; provision of higher quality, better paid and sustainable employment; improved access to markets and many more (USAID,

2005). It is important to note that the consequences of informality are dire as it means that those in the informal economy do not have access to appropriate technology, social protection and public services, thereby worsening their vulnerability and poverty levels. Despite the size and importance of the informal economy and the benefits of formalization, the informal economy in Nigeria is far from being formalized. Why is this so? What are the factors that drive informality? What are the factors that inhibit informality? These are the questions the study seeks to answer. The quest to find answers to the research problem leads to the following objective of the study: To identify the factors that drives and inhibits informality. Other objectives include identifying the characteristics and importance of Nigeria's informal economy.

## THEORETICAL LITERATURE

### **Conceptualization of Informality and Formalization**

The meaning of formalization is not clear cut as it is a dynamic concept and differs from one country to another and the meaning changes from time to time. On one hand a formal enterprise may mean any enterprise that pays tax to government, but most informal enterprises pay one form of tax, levy, toll or the other. For instance, a typical market woman at Ogbete Main Market (the largest and most popular market in Enugu Urban) pays a daily toll to the Local Government Area Council for the space her table or ware occupies in the market. Thus, if formality is regarded only on the basis of tax payment, she will be considered to be formal. On another hand, an enterprise may be formally registered with the appropriate regulatory agency (Corporate Affairs Commission (CAC), in the case of Nigeria) but does not pay taxes (or at most pays tax that is not commensurate with the size of business) and does not follow labour regulations for the purpose pension. Such an enterprise may not be considered as a formal enterprise.

Another notion that quickly comes to mind when informality is mentioned is that the business so concerned is an illegal one such as prostitution, gambling etc and thus, not captured in the nation's economic statistics. In this regard, the informal economy is the underground economy. This may not necessary be true as there are many enterprises engaged in legal activities which are not captured in the economic statistics of the economy.

It is due to these differences in conceptualization that Chambwera, MacGregor & Baker (2011) identified three major types of informal economy: illegal activities; legal activities with undeclared sources of income (tax evasion); and legal activities with transactions that have no legal tax obligation (tax avoidance). Schneider (2002) defined the informal economy broadly as any economic activity or income source that is not subjected to any government regulation, taxation or observation. Ogbuabor and Malaolu (2013) followed similar route in their definition of informality to mean the absence of government regulation which includes regulation of prices of inputs, control of exit or entry, disclosure of production process information, safety and health standards. Becker (2004) defined the informal economy as the unregistered non-formal portion of the market

economy that produces goods and services for sale or for other forms of remuneration and includes all economic activities by workers and participants that are not covered or are not sufficiently covered by formal arrangements.

For International Labour Organization (ILO) as reported by Chambwera et. al. (2011), informal economy has two categories which represent the type of activities engaged by their practitioners: coping strategy (which involve survival activities engaged by people who are unable to get employment in the formal sector as they wait for opportunities to be employed in the formal sector) and unofficial earning strategies (which includes illegal and criminal activities and unregistered businesses). Gbanor (2007) also followed similar definition to include two types of informality: illegal economic activity and none reporting of legal economic activity.

From the ongoing discussion, an informal economy is that part of an economy that includes all economic activities that operate without registration and regulation by the government and there is no clear-cut separation between the persona running the business and the business itself.

The informal economy is very critical to the survival of an economy especially the developing economy. It is a major contributor to GDP and a source of employment to the large number of unemployed people. Like the ILO (2007) identified, informal activity is a survivalist mechanism which provide a safety net for those who are lose their jobs or are unable to find job in the formal setting. The marginalized and disadvantaged members of the society which include the poor, women, people living with disabilities, people living with HIV/AIDS etc are easily employed in the informal economy which makes it a veritable key for achieving the Sustainable Development Goals (SDGs). The characteristics of the informal economy make it very flexible and resilient to the vagaries of economic recession and it can be a veritable tool for poverty alleviation. The preponderance of the informal sector is an indicator of the entrepreneurial potentials of the economy. The very nature of the informal economy: ease of entry and exist; low requirement in education, skills, capital and technology etc gives it a significant potential in job and income generation (ILO, 2007).

However, despite these numerous roles, it is of immense important that informal enterprises are formalized. According to Chen (2007), formalization is a system that includes regulated economic activities/units, protected workers and a formal regulatory environment which includes government policies, laws and regulations (Chen, 2007). The benefits of formalization are covered by many literatures. Some of these benefits stem from disadvantages faced by workers and owners of in formal enterprises. For instance, workers in the informal sector face certain challenges, namely: working in unsafe and unhealthy environment; low productivity, resulting in low and irregular income; lack of access to markets and resources; lack of protection from exploitation etc. (ILO, 2007). The inherent benefits of formalization have inspired entrepreneurs, policy makers and donor agencies to reduce the size of the informal economy so as to help in planning,

policy making and implementation (USAID, 2005). This will help to strengthen policy advocacy and reduce information differentials. USAID (2005) opined that formalization is important so as to provide employment that is of higher quality, better paid and sustainable in which the employees will not be taken advantage of by the employer. It went further to identify that formalization is also a way to broaden the tax base of the government and is also an avenue to enforce and reinforce contracts and strengthen agreements between investors. This will help to build the confidence of investors. Other benefits include increase in cashless activity which will increase financial resources for intermediation; improved access to business services, formal markets, and productive resources such as capital, land etc; and increased welfare of marginalized groups in the informal economy by providing opportunities to be active in the formal sector. According to Ferreira-Tiryaki (2008), three factors prevent businesses from formalizing, and they include: limited enforcement of legal obligations; the high cost of operating formally; and the level of trust (or mistrust) for government and its agencies. Saavedra-Chanduvi (2007) identified bureaucracy, corruption and burdensome regulation as the causes of informality. For Loayza (2016), informality is a symptom of bad governance and underdevelopment.

## **EMPIRICAL LITERATURE**

Empirical literature on inhibitors and drivers of informality is scarce. However, Loayza and Rigolini (2006) studied the factors that affect the size of informality in 18 developing and 24 developed high-income countries using self-employment as a measure of informality. They found that informality is counter-cyclical; is larger in countries with lower GDP per capita with higher costs of formality (rigid business regulations) and weak monitoring of informality (weak policy and judicial systems). In short-term business cycle, it is a buffer that expands in economic recessions or during temporarily high tax regimes. It can also vary in counter-cyclical response: lower in countries with high levels of formal employment and rule of law.

Oduh et. al. (2008) also sought to find the size and determinants of informality between 1970 and 2005 using survey data. This data was obtained from 4455 informal enterprises in 11 states of the South-East and south-South regions of Nigeria. They found that the size of the informal was about 44% of GDP in 1970 and 73% of GDP in 2005. Income, high tax burden, high black-market premium and huge government control were identified as drivers of informality.

Ogbuabor & Malaolu (2013) used Multiple Indicator Multiple Causes (MIMIC) error correction model to study the size and causes of informal sector in the Nigerian economy using secondary data from 1970 to 2010. They found that the informal sector was about 53.6% of GDP in 1970 and 77.2% of GDP in 2010 which is an average of 64.61% of GDP for the period. They also found that the major causes of informality are: unemployment, inflation, tax burden and real government consumption. Factors that propel informality in Nigeria were identified by Adele, Oyedokun, Adewoye and Afolabi (2015) using primary data

collected through structured questionnaire administered on 150 entrepreneurs of Entrepreneurship Development Centre (EDC), Ibadan metropolis. Data were analyzed using Multiple Regression and found that traditional culture, norms and values motivate informal entrepreneurship while formal rules/principles were generally perceived as impositions. In a study of group of developed and developing countries, Laoyza (2016) found, using simple correlation coefficient found an inverse relationship between informality and: business regulatory freedom; public service (law and order); and level of education.

## METHODOLOGY

The study used secondary data obtained from the 2010 National MSME Collaborative Survey between National Bureau of Statistics (NBS) and Small and Medium Enterprises Development Agency of Nigeria (SMEDAN) on activities of MSMEs to identify the size, characteristics and importance of Nigeria’s informal sector. Available literatures were used to gather materials used to identify the factors that drive and inhibit informality in Nigeria. Descriptive statistic was used to make content and narrative analysis.

## DATA PRESENTATION AND ANALYSIS

### **Size, Characteristics and Importance of Nigeria’s Informal Economy**

The 2010 National MSME Collaborative Survey made a distinction between a formal economy and an informal economy using the classifications of the National Policy on MSMEs. Table 1 shows the criteria used to classify enterprises into micro, small and medium enterprises.

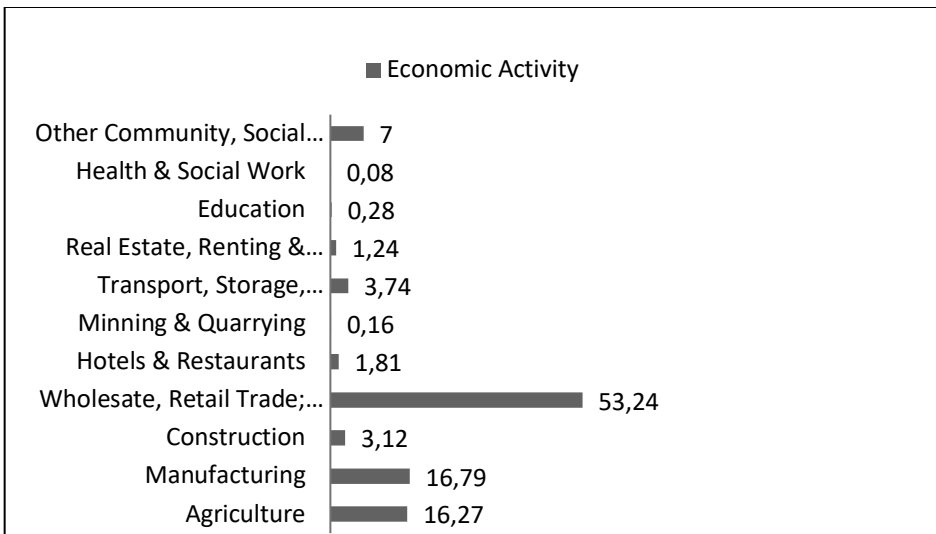
**TABLE 1**  
**Classification of Enterprises**

Sector	Criteria	
	Employment	Asset in ₦—million (excluding land and building)
<b>Micro</b>	Less than 10	Less than 5
<b>Small</b>	10 to 49	5 to less than 50
<b>Medium</b>	50 to 199	50 to less than 500

Source: Small and Medium Enterprises Development Agency of Nigeria, 2010.

According to the National Policy on MSMEs, a micro enterprise is one that has less than 10 employees and has an asset (excluding land and building) worth less than ₦5 million. On the other hand, a small enterprise employs about 10 to 49 people with an asset of between from N5 million and less than N50 million while the medium enterprise has 50 to 199 employees and an asset worth from N50 million to less than N500 million. Peradventure where there is a conflict between the two criteria, the employment-based classification takes preeminence. Following this classification, the Survey identified the informal economy as comprising of enterprises that were classified to be micro enterprises while the

formal economy were those classified as small and medium enterprises. The survey found that there were 17,284,671 MSMEs in Nigeria, out of which 17,261,753 (99.87%) were micro enterprises (informal economy) while 21,264 (0.12%) were small scale enterprises and 1,654 (0.01%) were medium enterprises. This shows that the size of the informal economy in Nigeria is very large. The Survey further classified the informal economy into the various economic activities engaged by the enterprises. Findings of the Survey are presented in figure 1 below.



Source: Small and Medium Enterprises Development Agency of Nigeria, 2010.

**FIGURE 1.** Economic Activity of The Informal Economy(%).

The survey found that trade (wholesale & retail); repair of motor vehicles and household goods constituted more than half (about 53%) of economic activity engaged in the informal economy. This is followed by manufacturing (16.79%) and agriculture (16.27%). The reason for this is not far-fetched: it is comparatively quite easy to start a trading enterprise both in terms of start-up fund and human and material resource requirements.

The sole proprietorship constituted the highest proportion of business organization in the informal economy. Data shows that 97.36% of the businesses were solely-owned. This form of business organization is the simplest type of business to start as well as the least regulated and controlled by government. Partnerships were 2.42% while cooperatives and faith-based businesses were 0.11% and 0.12% respectively. Data shows that about 58% of enterprises in the informal economy are owned by males while the rest are owned by females. In support of the definition that the informal economy consists of unregistered and unregulated enterprises, data shows that a little above 95% of the enterprises are not registered with CAC. The rest of the enterprises are registered with the CAC.

### Contributions of the Informal Economy to Nigeria's Economy

Total nominal GDP for year 2010 was N33,984,754.13 million. The MSMEs made total contribution of N15,817,812.50 million which represents 46.54% of Nigeria's GDP 2010 (National MSMEs Survey). Out of this MSMEs contribution, the informal economy's contribution was N8,869,195.68, representing 50.07% of MSMEs' contribution to GDP and 27% to total GDP. In terms of employment generation, the informal economy was found to have made remarkable contribution as a source of employment. As at December, 2010, the informal economy generated a total employment of 32,375,406 which comprised 15,641,460 persons engaged and 16,733,946 business owners (Small and Medium Enterprises Development Agency of Nigeria, 2010).

### Factors that Drive Informality

These are those barriers or challenges that hinder informal business from becoming formal despite the identified benefits of formalization. It also includes those factors that make hitherto formal enterprises to revert to informality. It is opined that removal of these factors will inhibit informality and increase formalization.

**1. High Cost of Enforcing Contracts:** Enforcement of contracts and legal obligations in Nigeria is very porous and weak and costly in terms of procedure and cost. Table 2 shows the time, cost and procedures for enforcing contracts in Nigeria. It shows that in 2010, average time (in days) it takes to enforce contracts is 457 days and this takes about 40 procedure and costs 92% of claims. By 2014, average time (in days) it takes to enforce contracts is 447 days and this takes about 40 procedure and costs 92% of claims. The ease of enforcing contracts in Nigeria reduced from rank of 138 in 2013 to rank of 136 in 2014.

**TABLE 2**  
**Enforcing Contracts**

Year	Time (Days)	Cost (% of claims)	Procedures (Number)	Rank (out of 189)	Regional Average (Sub-Saharan Africa)
2010	457	92	40		
2011	457	92	40		
2012	457	92	40		
2013	457	92	40	138	
2014	447	92	40	136	
2015*	509.8	57.7	40.2	140	121

Source: The World Bank, 2018.

**2. High Cost of Starting a Business:** The cost of starting a new business in the formal sector requires lots of resources. To receive a permit and all necessary documentations to start a business in 2013 required 25 days, 8 procedures and cost 63.1% of income per capita. In that same year, Nigeria ranked 114 out of 189 economies. The scenario did not change much by 2014 as it took the same number of days and procedures as in previous year, but the cost per capita income was

58.3% even though Nigeria's rank worsened 122 out of 189. Table 3 below shows the time, cost and procedures involved to start a business.

**TABLE 3**  
**Starting a Business**

Year	Time (Days)	Cost (% of income per capita)	Paid-in Minimum (% of income per capita)	Procedures (No)	Rank (out of 189)	Regional Average (Sub-Saharan Africa)
2010	25	73.8	0	8		
2011	25	75.8	0	8		
2012	28	67.9	0	8		
2013	28	63.1	0	8	114	
2014	28	58.3	0	8	122	
2015*	30.8	31.6	0	30.8	129	129

Source: The World Bank, 2018.

3. **High Cost of Getting Infrastructure:** Infrastructure is very critical in growth and productivity of any business. One major problem bedeviling Nigeria is lack and inadequate supply of critical infrastructures such as good roads, electricity, portable water etc. Getting connected to electricity in Nigeria took 260 days in 2010 as well as 2014 but 1432.7% of income per capita in 2010 and 960.5% in 2014. It also took 8 procedures in both years. However, Nigeria's rank dropped from 184 in 2013 to 185 in 2014. See table 4.

**TABLE 4**  
**Getting Electricity**

Year	Time (Days)	Cost (% of income per capita)	Procedures (No)	Rank (out of 189)	Regional Average (Sub-Saharan Africa)
2010	260	1432.70	8		
2011	260	1474.60	8		
2012	260	1319.30	8		
2013	260	1086.80	8	184	
2014	260	960.50	8	185	
2015*	257.2	478	9.8	187	139

Source: The World Bank, 2018.

4. **Multiple and High Taxation:** The amount of taxes paid by a typical business in Nigeria is many as well as high. Our findings show that 35 different kinds of taxes were paid in 2012 by business owners, which were found to increase to 47 payments in 2014. The total tax rate in 2012 was 32.7% and it increased to 33.8% in 2014. Nigeria's rank worsened from 167 in 2013 to 170 in 2014. Table 5 below clearly displays the tax trend Nigeria is facing. Even though it remained the same



for 2013 – 2015 it was quite a jump from the prior year. Once countries increase their tax rates it is difficult for a country to reduce the rate.

**TABLE 5**  
**Paying Taxes**

Year	Paym ents (No. Per Year)	Time (Hours per year)	Profit tax (%)	Labour Tax Contrib ution (%)	Other Taxes (%)	Total Tax Rate (%)	Rank (out of 189)	Regiona l Average (Sub- Sahara n Africa)
2010	35	938	-	-	-	32.2		
2011	35	938	-	-	-	32.2		
2012	35	938	-	-	-	32.7		
2013	47	956	22.3	10.8	0.7	33.8	167	
2014	47	956	22.3	10.8	0.7	33.8	170	
2015	47	907.9	32.7	-	-	-	179	129

\*

Source: The World Bank, 2018.

**5. Macroeconomic Instability:** Macroeconomic variables and indicators are highly volatile and unstable. This brings about uncertainties which do not augur well for business success, sustenance and stability. Poverty, underemployment and unemployment are very high in Nigeria and the informal economy is a coping mechanism for many people. For instance, Nigeria's unemployment rate was put at 24.3% in 2012 and 30% in 2013 (General Household Survey Report/NBS/CBN Surveys) while inflation rate was at 12.2% in 2012 and 8.3% in 2013 (WDI, 2018). These coupled with the dwindling oil revenue and depreciating Naira has left the economy in precarious position. Thus, formalization of business is not in the front burner of most small business but how to remain afloat.

**6. Poor Performances of Government and its Institutions:** There exists a large dose of mistrust of government by a vast majority of Nigeria citizens. This is owing to under performance by government and its agencies. A typical business in Nigeria provides its own water, electricity and security. Thus, these businesses see no reason to pay taxes to support government programs. With the high level of corruption and personal aggrandizement of public officials, most Nigerians view non-payment of taxes (and thus informality) as a way of getting their own share of national cake.

**7. Cultural Orientation:** Our culture permits some level of informality. For instance, transfer of wealth in Nigeria from father to son is almost automatic and does not need any form of formalization. This leads to a situation where capital gain tax, wealth transfer tax etc. are not paid. So also, most employment contracts are informal as the employers are most times related to their employees either by blood or marriage. Thus, there is little or no need for formalization of employment contracts.

**8. Level of Development :** Informality is both a symptom as well as a cause of underdevelopment. Most markets and institutions on which formalization thrive on are yet to be fully developed. For instance, the formal financial market is yet to incorporate all levels of businesses especially with regards to giving credits. The informal businesses then resort to the informal financial market to bridge this lacuna. Most small-scale businesses are yet to adopt modern business practices, coupled with trade by batter which is still rampant in Nigeria and these encourage informality.

### Factors that Inhibit Formality

**1. Information and enlightenment:** Access to information is critical to the transition from informality to formalization and this is lacking. Available data as depicted in table 6 shows that more than 95% of micro entrepreneurs are not aware of the existence and workings of SMEDAN, the major agency involved in promoting entrepreneurial activities of small businesses. This shows that informality may not necessarily be out of choice but because the operators may not have the necessary information on how to transit from informality to formalization and may not know the benefits inherent thereof.

**TABLE 6**  
**Awareness of Smedan by Micro Entrepreneurs**

Aware	Not Aware	Total (%)
<b>821,540</b> <b>(4.79%)</b>	16,330,828 (95.21%)	17,152,368 (100%)

Source: Small and Medium Enterprises Development Agency of Nigeria, 2010.

**2. Provision of necessary infrastructure:** One major role of government is to provide those goods and services individuals cannot provide efficiently and effectively. If individuals now provide these goods and services, they will see no reason why they have to obey government regulations and pay taxes inherent in such obedience. When these goods and services are provided adequately by government effectively and efficiently, it will encourage people to pay for them at the right place and at the right time and no cut corners in order to have the goods and services.

**3. Enforcement of regulations:** Nigeria is a country of many paradoxes: one on hand, starting a formal business in Nigeria is tedious and costly; on the other hand, it is easy to start a business without much ado in Nigeria. A typical hair dressing, tailoring, eatery, grocery etc. can start and operate without any registration or license. This is quite unlike developed countries where a permit or license must be obtained for every business. Thus, there is need to enforce some level of compliance in obtaining a simple permit for any business to start and operate.

## CONCLUSION AND RECOMMENDATIONS

Operating a small business in Nigeria is first and foremost a coping strategy to cushion the effects of poverty, underemployment and unemployment. Most often

than not, these businesses are run in ad hoc manner with no plan for the future, probably due to ease of entry and exit and the small-scale operation. For any business to succeed in this age and go beyond the coping mechanism, the business must be formalized. The benefits of formalization are many: for higher quality and sustainable jobs; better access to business services; to broaden tax base etc. Formalization also leads to better planning and implementation of government policies. Despite these benefits, many micro scale businesses in Nigeria are still operating informally due to their very nature and some difficulties they face.

The study was embarked with the objectives of identifying the factors that drive and inhibit informality as well as identifying the characteristics and importance of Nigeria's informal economy. The study found that 99.87% of the MSMEs are informal and their areas of operation are varied with about half of them in the wholesale and retail trade. The study also found that 97% are sole proprietorship while about 95% were not registered with the CAC, supporting the evidence that they are the informal economy.

Several drivers of informality were identified, and they include: high cost of enforcing contract; high cost of starting business and getting infrastructure; high and multiple taxations; macroeconomic instability; cultural orientation; level of development among many others.

It is on the basis of these that the following recommendations were proffered:

- SMEDAN and other government agencies like CAC should educate and inform small businesses of the advantages of formalization as well as the procedures for formalization. This will encourage business owners to register their businesses.
- There should be a legislation that compels all businesses to obtain a permit before starting so that they will operate in line with international best practices. The process of getting this permit should be very simple.
- Government should make the costs and procedures of enforcing contracts and starting a business as simple and transparent as possible.
- Government should provide critical infrastructure efficiently and effectively so that people will be encouraged to pay at the right place. The process of tax payment should also be made simple.
- Multiple taxations by all tiers of government should be discouraged.

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