

# The Urban Informal Sector of Pakistan: Some Stylized Facts

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# CONTENTS

	<i>Page</i>
<b>I. Introduction</b>	<b>1</b>
<b>II. Data</b>	<b>2</b>
<b>III. Characteristics of the Self-employed</b>	<b>3</b>
(a) Age of the Self-employed	4
(b) Education and Training of the Self-employed	5
(c) Family Background of the Self-employed	6
(d) Experience of the Self-employed	6
(e) Supplementary Sources of Income for the Self-employed	7
<b>IV. Characteristics of the Informal Sector</b>	<b>7</b>
(a) Single and Joint Ownership	7
(b) Ownership of Premises	7
(c) Age of the Firm	8
<b>V. Subcontracting in the Informal Sector</b>	<b>9</b>
<b>VI. Labour Force in the Informal Sector</b>	<b>10</b>
(a) Labour Force by Employment Status	10
(b) Skill Formation in the Informal Sector	11
(c) Gender Distribution	12
(d) Job Preference of the Self-employed	13
(e) Hours of Work in the Informal Sector	14



	<i>Page</i>
VII. Wages and Fringe Benefits in the Informal Sector	14
VIII. Efficiency of Informal Sector Enterprises	15
(a) Capital-intensity	15
(b) Productivity of Labour	17
(c) Potential for Improving Productivity in the Informal Sector	18
IX. Investment Requirements and Sources of Funds in the Informal Sector	19
X. Concluding Remarks and Policy Suggestions	20
References	22
Abstract	24

#### List of Tables

Table 1. Percentage Distribution of Self-employed in Different Age Groups	4
Table 2. Percentage Distribution of Firms by Number of Years the Firms has been in Existence by Industry	8
Table 3. Distribution of Workers in the Informal Sector	11
Table 4. Capital- and Labour-Productivity and Capital-Labour Ratio	16

## I. INTRODUCTION

Despite rapid growth of GDP in Pakistan, employment opportunities have been quite inadequate to absorb the rapidly increasing work force. This situation emerged because of the way industrialization was promoted in Pakistan; trade, investment and public sector policies promoted the capital-intensive large-scale industries, while they discriminated against the informal sector.

The informal sector undoubtedly generates higher employment than the formal sector for any given investment and have relatively high capital productivity but the productivity of labour in the informal sector is, presumably, relatively low and workers have no protection against exploitation by the employers who despite long hours earn meager wages. Therefore, the *prima facie* case for policy interventions in favour of the informal sector must rest on the fact that the labour-intensive informal sector generates more employment. At the same time public policy should also help to enhance the productivity of labour in the informal sector so that no compromise is made on the growth objective and on protection of workers against exploitation.

Informal sector enterprises, in general, are more efficient than the formal sector enterprises due to their efficiency in the resource use. However, some informal sector activities are inefficient and they survive merely by evading taxes and violating state regulations including labour laws. Such activities need not be encouraged and as such instead of providing subsidies in the form of tax exemptions, emphasis should be placed on the removal of constraints on the informal sector and to operate schemes which upgrade their skills, improve their technology help them in marketing, etc.



A number of studies have been carried out on the informal sector in Pakistan. These include, among others, Aftab (1990), Ahmad and Arshad (1990), Burki (1989), Chaudhary (1990), Ferks, Thomas and Tomesen (1989), Guisinger and Irfan (1980), Kazi (1987), Kemal and Mahmood (1993), Kibria (1990), and Mahmood (1990), Nadvi (1990). These studies examine various aspects of the informal sector in Pakistan including wage rates, labour productivity, capital-intensity, skill development and constraints on the growth. Since most of these studies are based on very small samples and generally in one or two locations, their results cannot be generalized.

In an effort to give concrete policy proposals for the promotion of the informal sector it is essential to know the basic characteristics and facts about this sector. This paper goes some way toward answering such questions as to who enters the informal sector, whether he/she earns higher level of income, what constraints are faced by these units, what is their capital intensity, etc. In particular, the paper focuses on the stylized facts, such as the characteristics of the self-employed and informal sector enterprises; the labour productivity and capital-intensity; constraints on the expansion of the informal sector; technological deficiencies; capital requirement and needs for the skill development, the employment potential in the informal sector; and the earning capacity of the self-employed and employees.

After this introductory section, data are discussed in section II. Section III to IX discusses the stylized facts of the informal sector, while concluding remarks and policy suggestions are reported in section X.

## II. DATA

Present study is based on a comprehensive survey of about 1500 urban informal sector enterprises. The sample ensures the inclusion of main production activities and the geographic distribution of the firms.<sup>1</sup> The survey was carried out in 11 major

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<sup>1</sup>Further details about the data and conduct of the survey can be seen in Kemal and Mahmood (1993).



cities, having large informal sector and drawn from all the four provinces of Pakistan.<sup>2</sup>

Four major economic sectors, viz. manufacturing, trade, transport, and services have been distinguished in the survey.<sup>3</sup> Number of enterprises in each of the sector has been determined by taking into consideration the relative importance of each sector in the GDP and employment and the heterogeneity of the economic activity within the sector. The manufacturing sector has been accorded maximum weight in the sample, because of its heterogeneity in terms of both the technology and the environment. The nature of economic activities in the informal sector and clusters of manufacturing, trade, and service activities in each city were ascertained in consultation with the local labour department and the sample was drawn in approximate proportion to the economic activities in the area.<sup>4</sup> The sample is sub-divided in the following proportions:

(a) Manufacturing	50 percent
(b) Trade	15 percent
(c) Transport	15 percent
(d) Services	20 percent

### III. CHARACTERISTICS OF THE SELF-EMPLOYED

Various factors, both economic and non-economic, influence an entrepreneur's choice to set up a business enterprise. The characteristics of individuals such as age of the self-employed, size of the household, family background, availability of funds, education

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<sup>2</sup>The sample included nine hundred units from Punjab, four hundred from Sindh and one hundred each from N.W.F.P. and Balochistan.

<sup>3</sup>The informal sector is present in almost every activity but its presence is most felt in manufacturing, trade, transport and the services sectors.

<sup>4</sup>The survey of 1500 units was carried out in the sampled proportions. However, certain questionnaires were left out of the analysis because either the data were incomplete or they were faulty. Therefore, the analysis presented in this paper relates only to 1417 units distributed over the four activities.



level, the training acquired, the experience and the possibilities of supplementary income play a crucial role on the decision to work and in the choice of profession.

### (a) Age of the Self-employed

Age of an entrepreneur underlies some of the factors influencing entrepreneur's decision to join the informal sector. While a pool of relatively younger entrepreneurs in the informal sector may imply that the informal sector is a transitional activity, the presence of relatively more mature self-employed may imply that the entrepreneurs consider as a permanent and preferred business choice.

Table 1 suggests that whereas 64 percent entrepreneurs were in the age group of 20-39 as many as 34 percent of them be in the age group of 40 and above. While it clearly suggests that quite a few entrepreneurs join the informal sector as long as they do not get a job in the formal sector, a substantial proportion of the self-employed take it as a permanent activity.

Table 1

#### *Percentage Distribution of Self-employed in Different Age Groups*

	Aver.	Age	11-14	15-19	20-24	25-29	30-34	35-39	40-44	45-49	50-54	55-59	60+
Manufacturing	37	0	1.1	9.4	17.4	18.2	17.5	11.5	8.2	7.7	3.7	5.3	
Services	35	0.3	2.3	15.6	17.9	15.9	18.3	9.3	6.0	4.3	5.6	4.3	
Trade	36	0	4.0	9.7	19.9	17.7	15.0	11.5	6.2	5.8	2.2	8.0	
Transport	35	0	4.0	10.2	17.3	20.0	15.6	10.7	8.9	6.7	1.3	5.3	
Total	36	0.1	2.2	10.9	17.9	17.9	17.0	10.9	7.6	6.5	3.5	5.5	

The relationship between age and the entrepreneurship can be better understood by comparing the age distribution of the self-employed in the informal sector with that of the age distribution of total labour force in the country. Whereas the age groups of 25-44 account for 39.8 percent of the total labour force, the promotion of self-employed in the informal sector belonging to the same age



group, was as high as 63.4 percent. On the other hand, the informal sector accounted for smaller proportions in age groups of less than 25 and more than 45 compared to their shares in the total labour force. The relatively higher proportion of younger self-employed in the informal sector than the labour force suggests that at very early age, individuals try for a job in the formal sector but some of them due to frustration of being under- or un-employed and others after gaining the necessary experience and saving some money quit the formal sector and set up their own businesses in the informal sector.<sup>5</sup> However, only the successful self-employed continue with the informal sector while others try to seek the job as wage employees in the informal or the formal sector. Very successful entrepreneurs make a graduation to medium- and large-sized firms and thus move out of the informal sector.

#### **(b) Education and Training of the Self-employed**

Quality and ability of entrepreneurship and productivity of labour varies positively with the investment in human-capital especially in the form of education and training.<sup>6</sup>

As many as 81 percent of informal sector entrepreneurs<sup>7</sup> are educated which compares rather favourably with the average of 58.6 percent of the labour force in the urban areas. Nevertheless, most of the entrepreneurs had only primary or secondary education even though some entrepreneurs had even the Post-graduate degrees.

As many as 55 percent of entrepreneurs had some kind of training but very few had the informal training. The proportion of entrepreneurs who had some kind of training is maximum in the services sector, i.e. 71.5 percent. Similarly, 68.4 percent entrepre-

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<sup>5</sup>The inference is also supported by the data on Sources of Finance. (See, section IX).

<sup>6</sup>Other forms of investment in human capital include migration and search for new jobs. these are out of the scope of the present paper and as such we do not discuss these.

<sup>7</sup>For this paper we define an educated person as the one with an education of at least primary level.



neurs in the manufacturing, and 25 percent in the transport sector were trained. Even though trading hardly required any training, yet all of the entrepreneurs reportedly were trained.

Entrepreneurs in the trade sector reputed that their job was not in accordance with the training they had acquired, while in other activities, 73 percent of the trained entrepreneurs reported that they had training suitable to their present business.

Only 5.7 percent of the entrepreneurs had the formal training. The most important source of formal training has been the technical schools (33.3 percent), followed by vocational (22.4 percent), polytechnics (17.7 percent) and other public and private sector institutions (26.6 percent).

### **(c) Family Background of the Self-employed**

It is generally believed that the family backgrounds of entrepreneurs, in particular the education and training of the father, determine the inter-generational occupational mobility and the growth potential of the informal sector. However, it seems that in case of Pakistan, father's education and the children's education levels do not have a significant and positive relationship. Whereas there has been a significant improvement in the education status of those whose fathers were illiterate or had low levels of education, there has been a major retrogression in case of those whose fathers had higher level of education. There has hardly been any change in the average status of the entrepreneurs in the manufacturing and trade sectors, while retrogression was observed in the services and transport sectors.

### **(d) Experience of the Self-employed**

Besides education and training, experience of entrepreneurs help them in running enterprise efficiently and successfully. Informal sector entrepreneurs are quite experienced. As many as 36 percent entrepreneurs had an experience of more than 15 years, 56 percent had an experience of more than 10 years and 81 percent had experience of more than five years in the business they are presently operating. Since entrepreneurs have experience in the other sectors



as well, the proportion of entrepreneurs with total experience of more than fifteen years is 35.9, more than ten years is 55.9 and 81.2 percent had experience of at least five years.

#### **(e) Supplementary Sources of Income for the Self-employed**

Some of the entrepreneurs run more than one business simultaneously to supplement their incomes mainly because they are either under-employed in the main business or they work as part time in the informal sector. The proportion of such entrepreneurs, however, is quite small, i.e. 0.73, 3.13, 0.90 and 4.53 percent in manufacturing, services, and trade and transport sectors. Their incomes, however, from the second job range between 14 to 50 thousand rupees.

### **IV. CHARACTERISTICS OF THE INFORMAL SECTOR**

Three characteristics of the informal sector, viz, single and joint ownership, permanency of their premises, and the age of the firm have been distinguished in this section.

#### **(a) Single and Joint Ownership**

A firm owned and operated by a single individual is usually confronted with a number of problems in its expansion, including the product diversification. However, the single owners which presumably do effect its growth generally own the informal sector enterprises of Pakistan. The partnerships are not very common and they account for less than ten percent of the informal sector enterprises.

In the jointly owned firms, the share of respondents, presumably the one responsible for running the business, in the capital invested in the enterprise has been less than half. This kind of pattern in investment reflects the fact that the active partner is compensated in the form of lower capital contribution.

#### **(b) Ownership of Premises**

The firms located in rented premises always face the possibility that the business shall have to be shifted to other premises which influences their long term pattern of investment and growth. Only 37



percent informal sector enterprises own the premises of their work place; 52.1 percent manufacturing firms, 20.9 percent firms in the services and 30.1 percent firms in the trade sector own their premises.<sup>8</sup>

### (c) Age of the Firm

Average age of a firm shows the stability of firms in a business. At the same time, a high growth rate of enterprises imply a more favourable entrepreneurial supply situation. Whereas, such data are hard to come by, the number of firms by age roughly indicate the number of firms joining the activity over a specified period of time.<sup>9</sup>

While about 14 percent of the informal sector enterprises have been in existence for more than twenty years, nearly 60 percent of the firms are less than 10 years old (see Table 2). The distribution of

Table 2

*Percentage Distribution of Firms by Number of Years  
the Firms has been in Existence by Industry*

Year	Manufacturing	Services	Trade	Transport	Total
1-5	32.5	26.7	38.1	28.9	31.5
6-10	26.4	27.7	24.7	32.8	27.8
11-15	17.0	16.9	14.8	16.7	16.4
16-20	10.9	8.8	10.3	12.2	10.6
21-25	6.5	7.3	4.9	4.1	5.7
26-30	2.5	6.0	4.5	3.1	4.0
31-35	0.9	3.8	0.9	1.3	1.7
36-40	1.2	2.5	1.4	0.5	1.4
41-45	1.1	-	0.4	0.4	0.5
46-50	0.7	-	-	-	0.2
51-55	0.3	-	-	-	0.1
56+	-	0.3	-	-	0.1

<sup>8</sup>No transporter in the informal sector owns premises. Normal practice in Pakistan is that the local governments normally provide transport stand facilities, though some big transporters do own their stands.

<sup>9</sup>The possibility, however, does exist that there may have been switch-over from one activity to another or from one city to another, yet these are the only data on the basis of which some meaningful conclusions can be drawn about the growth in the number of firms.



firms by vintage in all the four activities shows that there has been a spectacular growth in all the informal sector activities over the last ten years; the number of enterprises have more than doubled in the past 10 years.

## V. SUBCONTRACTING IN THE INFORMAL SECTOR

Sub-contracting is one of the main sources of demand for the informal sector firms, especially in the manufacturing sector. The informal sector enterprises, in Pakistan, have been sub-contractors to both the other units in the informal sector as well as to firms operating in the formal sector.

Subcontracting leads to lower production costs, as the firms specialize in the production of different components. Sometimes large firms sub-contract a part of their production to small firms with a view to avoiding tax and labour regulations, while the small firms sub-contract to overcome the limitation of capital and to enjoy benefit from high turn-over.

Sub-contracting in Pakistan is prevalent in the manufacturing sector and to some extent in the trade and services sectors; 63 percent of the manufacturing sector firms practice sub-contracting while only 3.5 percent traders<sup>10</sup> and 1.9 percent firms in the services sector practice sub-contracting. In general, sub-contracting is done for the formal sector enterprises.

The sub-contractors are sometimes provided with raw materials for processing mainly because sub-contractors want design and quality of products according to their specifications. Almost 25 percent of the firms which practice sub-contracting are provided with raw materials. Some of the manufacturers who do not receive raw materials from the contractor get some cash in advance and the sub-contractors, in return, provide some rebate. However, the practice of

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<sup>10</sup>Trade firms sub-contract the production of goods to other informal sector enterprises by placing orders on the small firms to supply goods in accordance with their specification and design. The traders also provide sometimes raw materials to the sub-contractors.



receiving cash in advance to purchase inputs has been less prevalent; only 8.5 percent manufacturing firms and 14.3 percent service firms which did subcontracting received cash in advance.

Firms which receive advances generally give rebates to cover financial charges borne by the contractor. Average rebate as a percentage of cash in advance paid by manufacturing and services firms are 1.72 percent and 3.57 percent, respectively.

## **VI. LABOUR FORCE IN THE INFORMAL SECTOR**

The informal sector has the capacity to absorb more labour than the formal sector. However, the workers are exploited by the employers in the informal sector in terms of longer hours of work and lower wages, and as such they need protection.

The average employment size of the informal sector enterprise comes out to be about 3.3 persons. It is 4.69 persons in the manufacturing, 2.0 persons in the services, and 1.87 persons in trade and 1.92 persons in the transport sector.

The labour force employed in the informal sector shows four interesting features. First as many as 84 percent workers are skilled; the proportion of skilled workers amongst females has been as high as 80.8 percent. Second, only 2.5 percent of the workers are females which is fairly lower than their share in the total urban labour force, i.e. 6.3 percent. Third, no female worker is engaged in transport activities. Fourth, all the work force in trade has reported themselves as skilled workers; as a matter of fact, not many had acquired any training—formal or informal. The traders, however, insist that selling goods is a specialized skill.

### **(a) Labour Force by Employment Status**

The self-employed and the family helpers account for half the employed workers while the employees account for about 43 percent of the employment. (See Table 3.) This distribution pattern of labour force by employment status is not much different from the pattern for the entire economy of the urban sector.



Self-employment is rather important in the non-manufacturing sectors where it accounts for about 47 to 53 percent of employed workers. However, the share of self-employed is only 16.3 percent in the manufacturing sector. Therefore, if the objective is to promote informal sector enterprises over the manufacturing establishments, just promotion of self-employment would not be sufficient. Efforts shall have to be made to expand the existing manufacturing enterprises and to protect the wage employees, who account for 73 percent of manufacturing employment, against the exploitation of the manufacturers.

Table 3

*Distribution of Workers in the Informal Sector*

Sector	No of Establishment	Total Workers (Numbers)	Percentage Distribution of Employed		
			Self Employed	Employee	Family Helper
Manufacturing	687	3219	16.3	72.7	11.0
Services	288	575	44.6	41.8	13.6
Trade	223	418	53.1	20.2	26.7
Transport	219	421	52.1	42.3	5.6
Total	1417	4633	42.5	43.0	14.5

**(b) Skill Formation in the Informal Sector**

Female workers in the informal sector are about two percent of the total labour force employed in the sector. In the informal manufacturing sector, females are about two percent of the labour force, but in the formal manufacturing sector they are 8.8 percent. On the other hand, the share of female workers in informal trade activities is 1.85 percent against 1.3 percent in the formal trade activities and in the services sector females formed 1.6 percent in the informal sector compared to 13.7 percent in the entire service sector in the urban areas. Thus the proportion of female workers in the informal manufacturing and services activities is far lower than that in the formal sector.



Whereas relatively larger proportion of the skilled females workers have been in the informal sector, very few unskilled female workers have been able to get employment in the informal sector and even these unskilled females are working only in the manufacturing sector.

Distribution of workers by male and female adult and by male and female children yields some interesting results. The informal sector comprises of 91.0 percent adult males, 4.9 percent children and 4.2 percent of adult females. There are no female children in any of the informal sector activities.<sup>11</sup>

It is encouraging to note that the child labour is not all that prevalent in the informal sector as some of the earlier studies have indicated. The highest proportion of child labour is found in the transport sector where children formed 8.8 percent of the work force; followed by 4.4 percent in the manufacturing sector, 4.2 percent in the services sector and 2.1 percent in the trade sector.

### **(c) Gender Distribution**

Major source of skill acquisition in the informal sector has been the Ustad-Shagird (Master-apprentice) system. In the form of shagirds, entrepreneurs find hardworking labour who work as hard as the regular or casual workers, but are paid very little. As many as 26.5 percent entrepreneurs admitted the cheap labour to be the motivation behind their decision to take shagirds.<sup>12</sup>

Entrepreneurs generally are reluctant to take shagirds and the entry is not free for the workers. This is because the shagirds in their teens have a tendency to run away. Therefore, training is imparted only to the close relatives or to those for which friends provide guarantees. As many as 21.5 percent relatives and 35.7 percent on personal guarantees were inducted as shagirds.

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<sup>11</sup>According to 1981 Census, 4.2 percent workers in urban areas were children.

<sup>12</sup>Ustad-Shagird system may be conceived as the one where both trainees and trainers benefit; former obtaining training at low opportunity cost and the latter getting cheap labour. In the absence of other training modes, the system contributes towards imparting skills. Yet it is probably the second- or the third-best solution.



Ustads first look at the learning potential and then ask for guarantees. As many as 40.8 percent entrepreneurs in the manufacturing sector gave maximum weight to the learning potential of the shagirds. In the services and trade sector, the percentage was no less significant, i.e. 36.7 and 35.0 percent respectively.

It is generally believed that training through the Ustad-Shagird system is very slow and is a long drawn process. On average, it takes 15.7 months in the manufacturing sector and 20.9 months in the service sector to train a shagird. Each manufacturing firm, on average, has trained 12.2 shagirds while the service firms and the traders have trained 8.5 and 4 shagirds respectively.

Formal education does not play much role in the acquisition of skill through the Ustad-Shagird system. Moreover, the entrepreneurs who feel that education helps the shagirds in the acquisition of skills, felt that primary or middle level education is sufficient to acquire the skill.

It is interesting to note that most of Shagirds continue to work for Ustad even after the completion of training either because they feel obliged or some binding contract prohibits them to leave Ustad for a specified period. As many as 70.8 percent Shagirds in the services sector, and 57.9 percent in the manufacturing sector were found working with Ustads. Those who leave ustad after sometimes, generally set up their own businesses in the same activity.

#### **(d) Job Preference of the Self-employed**

A rational entrepreneur allocates resources to an activity where the expected rate of return is the maximum, i.e. an entrepreneur tries to maximize return on both the physical as well as human capital. However, sometimes entrepreneurs is constrained to pursue the preferred business. Lack of physical capital, is the major constraining factor; 42 percent of the entrepreneurs reported it to be a major problem. The other constraining factors include the non-availability of suitable premises, lack of raw materials, lack of suitable machinery, lack of technical workers, inadequate demand



for the product and government regulations. Not surprisingly, government regulations are the least cited factor which constrained entrepreneurs to take up the preferred jobs or to start a preferred business.

#### **(e) Hours of Work in the Informal Sector**

The workers in the informal sector, on average, work for sixty hours per week compared to 45 hours in the formal sector. Family helpers and casual workers have to work the maximum number of hours, but even shagirds work as much as 55 hours per week. The entrepreneurs themselves work for almost 59 hours.

Males in the informal sector tend to work longer hours than the females<sup>13</sup>. For example, male family helpers, on average, worked for 61 hours per week but female family helpers worked for only 32.7 hours. This is also true for the self-employed female workers in the manufacturing sector. For instance, whereas male self-employed worked for 56.2 hours a week, female self-employed, on average, worked for 45.4 hours a week.

### **VII. WAGES AND FRINGE BENEFITS IN THE INFORMAL SECTOR**

Workers receive remunerations for the services to any enterprise. Despite working rather long hours, the informal sector employees are poorly paid. They do not get higher wage rates commensurate with longer hours of work and receive lower fringe benefits than the formal sector enterprise.

Earnings of the self-employed, on average, have been Rs 5,675 per month which is almost four times the wage rate in the informal sector. However, their earnings comprise both of wages as well as their profits. The wages of the regular employees, on average, exceeds a little that of the casual workers and is similar to that of the unskilled workers in the construction sector; the average monthly

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<sup>13</sup>But interestingly enough, the female family helpers in the service sector work longer hours than the males.



wages of regular and casual workers in the informal sector have been Rs 1,633 and Rs 1,577 respectively. These wages are significantly lower than the wages of their counterparts in the formal sector. The wages of family helpers are quite similar to those of the casual worker, i.e. Rs 1,573, but the shagirds, on average, have been paid only one-third of the wages of the regular employee.

In addition to wages, the employees also receive fringes in the form of bonuses and commissions. Besides, workers in the services, trade, transport and manufacturing sectors, also receive benefits including free meals (in certain cases) medical allowance.<sup>14</sup> Ironically, almost one-fourth entrepreneurs did not pay the wages to their workers during the sickness.

### VIII. EFFICIENCY OF INFORMAL SECTOR ENTERPRISES

The rapid growth of the informal sector in the face of stiff competition from the organized sector suggests that the informal sector activities are efficient. Since the low capital-intensity is the hallmark of the informal sector enterprises, capital-labour ratio, capital-output ratios and productivity of capital have been examined in this section. It also examines the impact of the exemptions from payment of sales taxes and excise duties and the exemptions from some labour regulations to the informal sector.

#### (a) Capital-intensity

There are three main problems in the estimation of the capital stock especially in the informal sector. First, since a large number of small firms are located in the residential areas and the same building is used for both the housing and the business purposes it is difficult to apportion the cost of buildings to the business activity.<sup>15</sup> Second,

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<sup>14</sup>Full coverage means payment of doctor's fee and medicines for the workers only. Generally such expenditures are very low amounting no more than Rs 10 per day.

<sup>15</sup>The problem has been overcome in this study by estimating capital stock which is both inclusive as well as exclusive of land and buildings.



a large number of entrepreneurs do not own buildings and/or equipments but hire these on rent. The value of capital in such cases has been imputed on the basis of the entrepreneur's valuation and/or on the basis of the value of capital reported by other similar entrepreneurs. Third, the estimation of value of capital at current prices becomes problematic because the capital is of different vintages and prices of equipment and building increase over time.<sup>16</sup>

Average capital-labour ratio in the informal sector was Rs 110,700 and if the land and buildings are excluded, it is Rs 17,180 (see, Table 4). The capital-labour ratio in the informal sector is substantially lower than the average capital-labour ratio for the entire economy (Rs 2,36,582 for the 1980/81 to 1991/92 period). Assuming that the informal sector enterprises are located in the residential premises, it, thus, has a potential to create upto 14 times more jobs than rest of the economy, with the given capital stock.

Table 4

*Capital- and Labour-Productivity and Capital-Labour Ratio*

(In 000 Rs)

Sector	Labour-Productivity	Capital Productivity		Capital Labour Ratio	
		Including Land & Building	Excluding Land & Building	Excluding Land & Building	Including Land & Building
Manufacturing	89.04	1.29	0.24	114.80	21.20
Services	41.47	1.62	0.10	69.70	4.34
Professional	43.54	1.34	0.00	58.20	0.00
Non-professional	39.39	1.81	0.11	71.20	4.34
Trade	92.95	1.23	0.09	171.40	12.11
Wholesale	71.88				
Retail	100.84				
Transport	47.71	1.04	1.02	-	20.20
Mechanical	66.76	-	1.23	-	82.40
Non-Mechanical	28.66	-	0.55	-	15.86
Total	84.84	1.28	0.29	110.70	17.18

<sup>16</sup>The value of capital reported in the paper is essentially the valuation by entrepreneurs.



Productivity of capital, defined as the inverse of capital-output ratio, in the informal sector, has been 1.28 and if land and buildings are excluded, it is as low as 0.29 (see Table 4). Compared to the capital-output ratio of around 3.0 in the country, the productivity of capital in the informal sector is, indeed, very high. It may be noted from Table 4 that the capital-output ratio is the least in transport, followed by trade, manufacturing and services.

### **(b) Productivity of Labour**

Labour productivity, defined as value-added per worker, in the informal sector, on average, has been Rs 84,840; the highest productivity of labour has been observed in trade, followed by manufacturing, transport and services sectors (see Table 4). The productivity level in each of the informal sector activity exceeds significantly than that for the whole economy. The finding that labour productivity in the informal sector is higher, is subject to two caveats. First, the survey may have yielded better estimates of earnings than the estimates of National Accounts due to better enumeration. Second, present estimates are of un-weighted labour productivity while National Accounts provide weighted estimates. Accordingly, it is more instructive to examine the productivity level by each activity.

Very sharp differences in both the capital-intensity as well as productivity of capital and labour in the manufacturing sector are quite visible. For instance, capital-intensity is very high in beverages, tobacco, wood & cork, and printing and publishing industries; capital-labour ratios in these industries exceed the average capital-labour ratios for the manufacturing sector (both formal and informal sectors). The capital-output ratio has also been higher in these industries. But surprisingly enough, productivity of labour in these industries is no higher than the average productivity of labour in manufacturing. These are the industries which are subject to sales taxes and excise duties in the formal sector and are surviving only by avoiding taxes. If they are subjected to the taxes, they may become non-viable in the informal sector.



Sharp differences across various manufacturing activities suggest that if labour absorption is the basic objective, government may have to be very selective in providing facilities to them. Any facility which promote inefficient industries in preference to efficient ones, needs to be withdrawn. On the other hand, all the constraints may be removed which restrict the growth of informal sector enterprises in any activity.

Like in the manufacturing sector, capital-intensity and productivity of capital and labour vary significantly across various services. While capital-output ratios and capital-labour ratios are highly correlated, productivity of labour is not much related to capital-intensity. It suggests that other factors including human capital may have played more role than the capital in raising the labour productivity in various service activities.

As expected the results show that mechanical transport is the most capital-intensive modes. Productivity of capital in these activities is lower than the average level of productivity in the transport sector. In this sector, however, productivity of labour is significantly related to capital-intensity. The capital-intensity and productivity of labour and capital varies significantly across various activities of the trade sector.

### **(c) Potential for Improving Productivity in the Informal Sector**

Due to certain policy-imposed and/or market-related constraints, the informal sector manufacturing and service activities have failed in realizing fully the potential of productivity.<sup>17</sup> A large proportion of firms are working below their full capacity level in the informal sector; in the manufacturing sector, 95.2 percent firms and in the services sector, 96.7 percent firms have unutilized capacity in varying degrees. The rate of under-utilization was 31.0 percent in the manufacturing sector and 19.9 percent in the services sector. The

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<sup>17</sup>None of the entrepreneurs in trade or transport sectors felt that productivity can be improved with the existing resources.



entrepreneurs in the manufacturing sector estimate that their output can increase by 37.2 percent and those in the services sector can increase their output by 53.1 percent without any addition to capital if the constraints including lack of demand, non-availability of raw materials, and government regulations are removed.

## **IX. INVESTMENT REQUIREMENTS AND SOURCES OF FUNDS IN THE INFORMAL SECTOR**

It is a common perception of the entrepreneurs that the lack of capital is the major constraining factor in effectively running the existing business and in expansion of their enterprises, and graduation of their firms from informal to modern lines of production. Lack of capital forces the entrepreneurs to use inferior methods of production, i.e. hand-driven tools and second-hand machinery, and ineffective techniques of procurement of raw materials and marketing of their finished products. In fact this problem is so acute and pervasive that all other problems including those relating to availability of raw materials and inadequate infrastructure, labour, marketing, etc. become in the ultimate analysis a problem of finance.

The major source of funds in all the activities of the informal sector is family savings. Family savings account, on average, for more than half the funds. They accounted for 53.9 percent of funds in the trade sector, 51.7 percent in the manufacturing sector, 49.3 percent in the services sector and for 44.7 percent in the transport sector.

Investment from own savings while working as wage employees is the second most important source of funds, confirming our earlier finding that wage employees make a transition to the informal sector in the role of self-employed after accumulating sufficient capital from their jobs in the formal sector. Such savings formed the highest proportion in the manufacturing sector followed by services, trade and transport sectors. Own savings from working abroad are also an important source of funding accounting for about 6.2 percent of total funds. Investment made out of foreign savings is



the highest in trade, followed by services, the manufacturing and the transport sectors. Use of farm income for investment in the urban informal sector is negligible.

Loans from banks account for 8.1 percent of funds. It has been an important source of investment but only in the manufacturing and transport sectors. In the services sector, it accounts for 4.0 percent of total funds and in the trade sector, the proportion is less than one percent. Even more importantly, loans from local moneylenders are negligible. Only the manufacturing and the trade sectors utilize this facility but even there quite sparingly while the transport and services sectors do not use this facility at all. This finding is opposite to the findings of earlier studies on the informal credit market especially for the transport sector.

Loans from relatives to set up the business is also important; the highest proportion of firms who used loans from relatives are in the transport sector followed by trade, services and manufacturing sectors.

The proportion of reinvested profits from the current business is also quite significant, especially in case of transport and services sector. Investment from reinvested profits of current business is almost one-half in the trade sector and one-tenth in the manufacturing sector.

## X. CONCLUDING REMARKS AND POLICY SUGGESTIONS

The informal sector of Pakistan is both large and growing rapidly. Considering its potential in generating employment opportunities, it needs to be promoted, by removing constraints on them. At the same time some of the informal sector has flourished only because of the tax exemptions and avoidance of labour regulations. Similarly, the workers are being exploited in the informal sector in terms of low wages and longer hours of work. It also encourages child labour and thus constrain the accumulation of human capital in the country.



Micro enterprises are labour-intensive and as such with limited availability of capital, they can be effectively utilized to generate productive employment. However, the existing structure of incentives discriminate against the informal sector enterprises. There is a need to rationalize the incentive structure to promote an efficient informal sector. While the exemptions from payment of sales taxes and excise taxes which interferes with efficient-resource allocation be withdrawn, the rate of import duty on commercial and industrial users be equalized so that they do not have to pay higher costs for imported raw materials.

Non-intervention of the government has been the main factor giving rise to buoyancy of the micro enterprises and as such they may be exempted from payments of various fees and cess under labour laws. However they must comply with the labour laws. They may not be allowed to exploit the workers, especially the child workers, by extending the working hours without adequately compensating them.

The micro-enterprises are the main source of the informal training, yet there are a number of problems associated with this form of skill acquisition. The Ustad-Shagird system plays a useful role in imparting skills to the workers. However, Ustads generally take quite long to impart skills. Moreover, such skills are sometimes even obsolete because the Ustad can impart only those skills which he had acquired himself. Since it is rather difficult to motivate the Ustad to leave his shop and attend a training course, mobile workshops can be quite useful in imparting new skills to the Ustads and the Shagirds as well. To provide practical training to the workers, new institutions providing non-formal training, i.e. institutions giving very practical training without going through long drawn syllabi, would be also quite helpful.

Low productivity of workers, especially in the service sectors, has mainly been due to the fact the workers are using out-dated hand tools. High rates of import duty make the imported tools expensive, while the quality of domestically produced hand tools, due to protection, has been rather poor. Allowing the import of tools freely



at minimum duty would help in resolving the problem.

The micro-enterprises have a large potential to expand, yet due to various constraints, they have failed to realize the potential. Lack of finances has been the major constraint. The institutional credit accounted for a very small proportion of the total investment in the informal sector. Non-availability of credit to micro enterprises has been due to two main factors: (i) higher transaction costs and risks which discourages the financial institutions to lend to micro enterprises and (ii) the informal sector enterprises do not have the required collateral. Instead of subsidy on the interest rate, the informal sector has always demanded greater availability of credit and concessions in the collateral, e.g. hypothecation of raw materials or machinery.

Demand for goods produced in the informal sector is the major constraining factor. In general, goods produced by the informal sector are of poor quality and are sub-standard. Government may consider providing facilities of testing, quality control and gradation against a nominal cost. Besides, same facilities of concessions in import duty be provided to sub-contractors as are provided to those who subcontract. A dissemination centre which helps in integrating the export markets with the micro-enterprises would be quite useful. Provision of the facilities of export finances to indirect exporters would also be helpful.

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### ABSTRACT

In order to prepare concrete policy proposals for the promotion of the informal sector, it is essential to have a knowledgeable account of the basic characteristics and facts about this sector. This report presents the stylized facts about the urban informal sector, such as the characteristics of the self-employed and informal sector enterprises; labour productivity and capital-intensity; constraints on the expansion of the informal sector; technological deficiencies; capital requirement and needs for the skill development, employment potential; and the earning capacity of the self-employed and employees. Keeping in view these stylized facts about the informal sector the report concludes with a set of concrete policy proposals for the promotion and generation of the informal sector.