

Urban Informal Economy: Causes, Constraints and Transition Intention: In the Case of Wolkite and Butajira Towns

AYAL ADAMU^{1*} MEKONEN MULUGETA²

1.MBA, Lecturer, Department of Management, Injibara University, Injibara, Ethiopia

2.MBA, Lecturer, Department of Management, Wolkite University, Wolkite, Ethiopia

Abstract

Informal sector plays a crucial role in urban poverty alleviation through creating jobs and reducing unemployment. As literature shows there are a number of reasons that drives the informal economy participants to enter to the informal sector and also there are a number of constraints that faces the informal economy participants when engaged in this sector. The main purpose of this study is to assess the cause, constraint and transition intention of urban informal economy participants in case of Gurage zone Wolkite and Butajira towns. Hence, descriptive research design with cross sectional survey was considered. Among the identified reasons by the respondent are “lack of enough capital to enter to formal sector,” “tight and unfair tax administration and regulations in the formal sector”, and “high unemployment “are the critical cause that enforce the urban informal economy participants to be informal. The major constraints that face the urban informal economy participants during operating their business on informal sectors are lack of social protection and labor legislation at the workplace and inadequate regulatory policies and regulations to address unique informal sector problems are highly ranked constraints that face on the participants of urban informal economy in Gurage zone Wolkite and Butajira towns. Based on the finding of the study the researchers recommend that, even if many firms may not be formalizing because of their own strategic reasons, the government shall make simplicity of business registration or licensing cost, equity in the tax system and providing tax-holidays for sometimes, increases the benefits of legal registration like more favorable credit terms and confidence in the taxing administration to enhance the environment for businesses to operate formally.

Keywords: Informal economy, causes, constraint, transition intention

1. INTRODUCTION

The informal economy is an important part of economic, social and political life in most developing, as well as some developed economies. In countries with high rates of population growth or urbanization, the informal economy tends to absorb most of the growing labor force (MoLSA, 2013). Informal economy is continuously expanding in developing countries and providing employment and income to the poor. It is stimulating the growth of the market economy, promoting flexible labor market, stimulating and absorbing labor than the formal economy. Specifically, urban informal economy is a major source of employment and income in developing countries. The sector has helped the impoverished groups of the urban population to improve their business skills and income levels required for business development (Asaminew, 2010).

According to Schneider and Enste (2000), economic activity that falls outside the purview of government accounting is known by various names as informal, hidden, underground, black, gray, clandestine, illegal or shadow. Informal economy refers to a home based or an individual establishment or an activity operated by the owner with a few or no employees, little or no access to organized markets, credit institutions, modern technologies, formal trainings, public services and without fixed shopping center (CSA, 2004). ILO (2002) defines informal economy “all economic activities which are not usually recognized, regulated, or protected by legal or regulatory frameworks”. Commonly, informal economies understood as socially desirable economic activities which produce goods and services which are considered in national account calculation but escapes from government observation, regulation and taxation (Schneider and Enste, 2000).The informal economies are largely characterized by low entry requirements in terms of capital and professional qualifications, small scale of operation and labor-intensive methods of production (owne, 2013).

A survey by word Bank (2008) indicated that urban informal sector accounts about 60% employment in Africa. Ethiopia has also experienced widespread informal economy between 1977-1991 while the country was under continuous civil war and instability providing a favorable condition for the development of informal economy. During this period, the average size of informal economy amounts 41.5% of the recorded economy (Asaminew, 2010).

Moreover, a latest study by international monetary fund on Ethiopian economy also revealed the informal economy in Ethiopia shares about of 38.6 percent of GDP with 31 percent employment opportunity. The study has also noted the contribution of informal economy for GDP greater than the average of 38.4 percent for SSA and 38 percent for all low-income countries (IMF, 2013).

Though informal economy important for socio-economic development in developing countries like Ethiopia the sector is facing constraints such as legal impediments, inadequate capital, and lack of appropriate skills to

operate businesses, unfavorable government regulation, lack of access to finance and lack of training, poor urban land administration and bureaucratic rules and regulations (Beker, 2004; ILO, 2004; HLCLEP, 2006).

Researchers have identified different causes of informal economy that enforces informal economy operators to engage in the informal economic activities. Ogbuabor and Malaolu (2013) note that unemployment, tax burden, government regulation, and inflation; Schneider (2006) increased burden of taxation and social security contributions and labor market regulation Similarly Tunyan (2005) tight and unfair tax administration and regulations and corruption.

In Ethiopia though informal economy greatly contributes for the socio-economic well-being through creating employment and incubating new entrepreneurs, researches on informal economy causes, transition intention and constrains are almost scanty.

Yet Ebisa (2012) assess the status of women in the informal sector with particular emphasis in south western Ethiopia- Gomma district. The researcher investigated different constraints facing women informal economy operators like slum and squatter settlements with poor conditions of houses, electricity, and water and drainage systems. Another scholar Habtamu (2013) investigated various types of economic linkages between formal and informal- economy in Hawassa-Ethiopia. In his study backward, forward, consumption and technological linkages between formal and informal economies are identified.

The above studies revealed that this sector is not sufficiently investigated and still demands a due attention. In line with the above empirical literatures this study intends to examine the major causes, constraints and transition intention of urban informal economy operators in the case of selected Gurage zone towns.

1.1. Objective of the Study

- ✚ To identify the causes of urban informal economy engagement in the study areas.
- ✚ To identify constraints facing urban informal economy operators in the study areas.
- ✚ To know urban informal economy operator's transition intention into formal economy.

2. METHODOLOGY OF STUDY

To meet the study objective, descriptive research design with cross sectional data was employed. The target population for this study was urban informal economy participants in wolkite and Butajira urban areas. The primary data was obtained from urban informal economy participants and the employees of the targeted institution in the study areas. Secondary data have been collected from different IMF and World Bank reports to get the target population and determine the sample size. The data were collected through primary and secondary data sources. The primary data were collected with the help of questionnaire, interview, and focus group discussion. The questionnaire consist both open and closed-ended questions. To triangulate the questionnaire response, an in-depth interview with key informants also was held. Besides focus group discussion, it held with selected urban informal operators and different government institutions like micro and small scale enterprise office, revenue and custom authority office, municipality and others. Regarding sampling design, wolkite and butajira urban areas were selected purposely. Because these two towns are most populated and have large number of individuals who are engage in informal economy.

According to IMF (2013) in Ethiopian economy the informal economy shares 31 percent employment opportunity. This means out of the total economically active population that 31 percent are involved in informal business. By having this, the following table shows the proportion of informal economy participants from the total economically active population in the study area.

Table 3.1. proportional Sample size determination

City	Total urban population	Economical Active population (69%) of the total	Population engaged In informal economy (31%) of the eco-active	Proportional sample taken
Wolkite	70,796	48,849	15,143	228
Butajira	50,922	35,137	10,892	166
Total	121,718	83,137	26,035	394

To determine the representative sample size Yemane (1967) finite population sample size formula with 95% confidence level is employed. Using the formula, 394 informal economy operators was sampled from the two strata. Of which 228 from Wolkite and 166 from Butajira Have been allocating proportionally by using proportionate stratified sampling method. In order to draw samples from the total population, snowball non probability sampling method was employed.

The formula applied to obtain the sample size is presented below.

$$n = \frac{N}{1 + N(e)^2}$$

Where:

n= Number of sample taken

N= Population size

e = sampling error /level of precision.

$$n = \frac{26035}{1+26035(0.05)^2} = 394$$

The data were analyzed with the help of descriptive statistics. In this study descriptive statistics like Mean, standard deviation, frequency and percentage were used as data summarization and analysis technique. In study used Norasmah (2005) mean score interpretation was adapted. Norasmah uses the 60th and the 70th percentile of scales to determine cutting points. Accordingly 60th percentile of,5,4,3,2,1 results 3.4 and 70th percentile of,5,4,3,2,1 results 3.8. Thus, mean score below 3.39 interpreted as low cause/ constraint, mean score from 3.4 – 3.79 interpreted moderate cause/ constraint and finally mean score 3.8 and above interpreted high cause/ constraint.

3. DATA ANALYSIS AND DISCUSSION

3.2. Descriptive statistics analysis of causes of urban informal sector engagement

Table 2. Mean and standard deviation of causes

Items	Mean	Std. Deviation	Scale
Lack of enough capital to engage to formal sector	4.17	.672	High
Tight and unfair tax administration and regulations in the formal sector	4.12	.814	High
cannot fulfilled minimum requirements to operating in formal sector	3.94	.862	High
High unemployment	3.80	.767	High
High registration fee and procedure in the formal sector	3.58	1.123	Moderate
low entry requirements in terms of capital and professional qualifications in the informal sector	3.52	1.134	Moderate
Lack of working place	3.43	1.112	Moderate
It is the only source of income	3.33	.924	Low
Complex government regulation for the formal sector	2.98	.950	Low
Non competitiveness in formal sector	2.90	.950	Low
Low salary payment in government jobs	2.68	.952	Low
It is highly profitable	2.56	.887	Low
Average	3.42	0.928	
Valid N (listwise)	N= 320		

Source: survey data, 2017

The above table 2 shows the identified among the reasons “Lack of enough capital to enter to formal sector”, “Tight and unfair tax administration and regulations in the formal sector”, “cannot fulfilled minimum requirements to operating in formal sector”, “increasing unemployment” are the critical causes or reasons that enforce the urban informal economy participants having the highest means equal to and greater than 3.8 mean value.

The above table 2 also indicated that “High registration fee and procedure in the formal sector”, “low entry requirements in terms of capital and professional qualifications in the informal sector” and “Lack of working place” are moderately ranked reasons.

Among the reasons that have the lowest mean value and weakly ranked by the respondent were “It is the only source of income”, “Complex government regulation for the formal sector”, “Non competitiveness in formal sector”, “Low salary payment in government jobs” and “the sector is highly profitable” having less than 3.4 mean value that inadequately enforce the urban informal economy respondents to enter to this sector and considered as a less favorable reason.

“Lack of enough capital to enter to formal sector” was the major causes for urban informal economy participants to entre to this sector that the item have the highest mean (M=4.17, SD 0.672). An in-depth interview held with selected urban informal economy operators and government officials also reviled that even though the government of Ethiopia is discouraging informality at significant fraction, insufficient capital remains to be the main challenges forcing firms to operate informally. Specifically, especially urban informal economy operators said that the insufficient capital is a significant indicator that differentiates between formal and informal. Based on this the researcher conclude that lack of enough capital to enter to formal sectors the main causes that makes the urban informal economy operators to be informal and extend with this sector.

The second identified causes for urban informal economy participants to entre to this sector was tight and unfair

tax administration and regulations in the formal sector with the second highest mean value ($M=4.12$, $SD=0.814$). An in-depth interview held with selected urban informal economy operators and government officials revealed that using the same percentage of income for tax but there is a high amount of income gap between level of taxes and tax is assigned in a relative compare with the income of the payers; this makes the tax administrations unfair. They also said that tax avoidance fraction is small especially to new businesses with small capital and the implementation of appropriate strategies to the regular registration of new opening small businesses. Based on this the researcher conclude that fear of the amount of tax paid by the formal sectors is one cause or factor that enforces Gurage zone selected urban informal sector participants to engage in this sector.

The above finding is similar to the finding of Ogbuabor and Malaolu (2013) that tax burden and government regulation is causes of informal economy engagement. In addition to this increased burden of taxation and government regulation (Schneider, 2006); tight and unfair tax administration and regulations and corruption (Tunyan, 2006); Government regulation, taxation, economic issues and social ethos (Jie *et al.*, 2010); burden of taxes and social security contributions, increased regulation in the official economy (Schneider and Enste, 2000); High taxation (Willemse, 2011); to avoid tax and to get higher profit (Sibhat, 2014) are some of the studies. Becker (2004) also identifies that the obvious benefits for entrepreneurs who operate in the informal economy are avoiding costly and burdensome government regulations as well as high and complex taxes. He also said that the reason why the informal sector is so large in developing countries is that the benefits of formality are dwarfed by its costs.

Cannot fulfilled minimum requirements to operating in formal sector was also the other reasons that enforces wolkite and butajira urban informal economy participants to enter to this business with the mean value ($M=3.94$, $SD=0.862$). This may be that one of the main characteristics of informal sector participants is that the skills acquired outside the normal school system, (ILO, 1972). The above result is in line with Sibhat (2013) result that majority of respondents perceived that they become informal sector because of the difficulty of entry into the formal sector that unable to fulfill minimum criteria of the sector or alternatively due to the ease of entry into the informal sector.

High unemployment is also the other major enforcing factor to enter to urban informal economy with mean value ($M=3.80$, $SD=0.767$). The interview result of the respondent shows that the informal sector is a last resort for the poor individuals with less education to earn a living in a poor. This may be attributing to a possible explanation that informal economy sectors can become effective creators of employment, income and growth. Supported by Sibhat (2014) result shows that the main reason of informal sectors to be informal is seeking of employment.

This is similar to the finding of Ogbuabor and Malaolu (2013); Jie *et al.*, (2010) that unemployment is one of the causes for informal economy engagement. Tambunan (2009) also identifying that they cannot find employment in the formal sector. The result of Willemse (2011) shows that the limited ability of the government and the formal business sector to provide sufficient employment opportunities to people in the economically active age categories is the main reasons for informal trading. Ebisa (2012) assess that informal sector is the only hope for a large number of women who are not able to find employment in the formal sector; Sibhat (2014) lack of job opportunity in the formal sector.

High registration fee and procedure to enter to the formal sector is the other moderately rate cause. This may shows the researcher find little evidence to support the theory that high registration costs are the primary barrier to firms leaving the informal sector. This is similar to the finding of Becker (2004) that excessive registration and transaction costs of starting or operating businesses. A survey by World Bank (2004) on indicators of starting a business on the formal sector in Ethiopia requires eight numbers of procedures, 44 numbers of days and costs 422 dollars on average related to other developing and developed countries.

Low entry requirements in terms of capital and professional qualifications in the informal sector is the other reason to enter to urban informal economy with mean value ($M=3.52$, $SD=1.134$). This shows that the informal economy operators can start a business by using a skill and capital what they have. This is in line with the study by Becker (2004) that informal economy is largely characterized by a small scale of operations, skills often acquired outside of formal education, low entry requirements in terms of capital and professional qualifications, and labor-intensive methods of production and adapted technology; relatively less entry barriers, low capital, and flexibility also a study result by (HLSLEP, 2006).

It is highly profitable ($M=2.56$, $SD=0.887$) is the weakly rated cause of urban informal sector engagement that by the respondents. Becker (2004) also describes that informal sector is characterized by Low incomes or lack of regular income as household consumption competes for the use of business earnings. Informal sector workers incomes are low and irregular and they have a very limited bargaining power to increase salaries (Chen, 2000).

3.2. Descriptive Measurement of constraints of urban informal sector

Table 3. Mean and standard deviation of constraints

Code	Items	Mean	Std. Deviation	Scale
C1	Lack of social protection and labor legislation at the workplace.	4.26	.927	High
C2	Inadequate regulatory policies and regulations to address unique informal sector problems.	4.10	.813	High
C3	Lack of safe nets in case of job loss, injury, sickness and death.	3.96	.787	High
C4	Difficulty of accessing finances due to lack micro credit and inadequacy of loans	3.90	1.016	High
C5	Absence of organized interest groups e.g. unions, associations to deal with government and solve the problems affecting the sector.	3.80	.967	High
C6	Lack of start-up capital	3.77	1.064	Moderate
C7	Traffic incidence and police harassment	3.67	.793	Moderate
C8	exposition to rain and sun	3.47	1.131	Moderate
C9	Customers perceive the products are low in terms of quality and price	3.21	.981	Low
C10	Lack of market network	2.43	.857	Low
C11	physical and verbal abuse especially for females	2.42	.852	Low
C12	Customers perceive the product is spoil, old or defective	2.40	.865	Low
C13	Inadequate skill	2.37	.842	Low
	Average	3.36	0.915	
	Valid N (listwise)	N=320		

Source: survey data, 2017

The above table 4.3 demonstrates the major constraints that face the urban informal economy participants during operating their business on informal sectors. Based on the presented data on the above table; Lack of social protection and labor legislation at the workplace; Inadequate regulatory policies and regulations to address unique informal sector problems; Lack of safe nets in case of job loss, injury, sickness and death; Difficulty of accessing finances due to lack micro credit and inadequacy of loans and absence of organized interest groups e.g. unions, associations to deal with government and solve the problems affecting the sector are highly ranked constraints that faces on the participants of urban informal economy in Gurage zone Wolkite and Butajira urban areas.

The identified constraint variables that moderately ranked by the respondent are Lack of start-up capital, Traffic incidence and police harassment and exposition to rain and sun during conducting their activity.

Customers perceive the products are low in terms of quality and price, Lack of market network and working place, physical and verbal abuse especially for females, Customers perceive the product is spoil, old or defective, Inadequate skill are weekly ranked problems by the respondents.

Lack of social protection and labor legislation at the workplace was the major constraints that faces urban informal economy participants when operating their business on this sector that the item have mean value (M=4.26, SD=.927). This may implies that even though, an informal economic unit may have its internal rules and regulations which may not be available to the public, yet the existence of such internal rules of behavior does not deliberate as a status of a formal enterprise. This result is in line with Amin (2002), informal employment comprised of both self-and wage-employment that are usually not recognized, regulated, or protected by legal or regulatory frameworks. CSA (2003) report also shows that informal economy in Ethiopia are not recognized, supported or regulated by the government and they are beyond social protection, labor legislation and protective measures at the workplace. Oduh *et al* (2008) defined an informal enterprise as one which operates without regulations prescribed by the public authority to govern its organizational behavior; unfavorable government regulation HLCLEP (2006); Lack of access to official social security schemes Becker (2004); Inadequate labor legislation, labor protection and social security schemes and have limited access to wage workers organizations (Chen, 2000). Lack of obtaining support from law enforcement officials to combat crime, high taxation, and the lack of general support are the study result by (Willemse, 2011).

Inadequate regulatory policies and regulations to address unique informal sector problems is another constraint faced by urban informal economy participants having the highest mean of (M=, 4.10, SD=.813). This is in line with Willemse (2011) is that Political conditions and policies often present difficulties to informal traders. The study reported that South African policies tend to restrict informal trading operations rather than facilitating them.

Lack of safe nets in case of job loss, injury, sickness and death (M =3.96, SD=0.787) and exposition to rain and sun (M=3.47 SD=,1.131) are one of the constraints faced by Wolkite and Butajira urban informal economy participants with the highest and Moderate mean respectively. In addition to this as a researcher observes that in

the area of occupation health and safety, majority of urban informal sector workers operate from their residential premises and others work from public places in temporary shed and structures; under trees or open spaces. Poor public and environmental health, in both the residential and market areas where informal sector workers operate is a major urban problem and jeopardizes the health of many informal workers.

Difficulty of accessing finances due to lack of micro credit and inadequacy of loans ($M= 3.90$, $SD =1.016$) is the fourth constraints rated by the respondents. The reason for this may be that informal economy enterprises cannot access finance from formal financial institutions generally available to the formal economy such as banks and other financing institutions etc. because this institution may require ownership rights as collateral for bank loans and most of this sector participants characteristics are low in income and operation and may not having this collateral. Tambunan (2009) said that if informal street vendors cannot provide collateral, they cannot obtain access to formal credit from banks for example. This is in line with CSA (2003) report that Ethiopian informal economy participants have little or no access to organized markets, to credit institutions, to modern technology, to formal training and to many public services and amenities. Lack of access to finance and lack of training HLCLEP (2006); Limited access to formal finance and banking institutions Becker (2004) also supports this result.

Absence of organized interest groups e.g. unions, associations to deal with government and solve the problems affecting the sector ($M=3.80$, $SD=0.967$) has been found as a challenge for informal sector participants when they operate their business. This may be as in Ethiopian case to form different unions and associations which would do for best interest of the sector minimum requirement is having formally registered and a license and the available unions and association's works and represent the formal sector.

Lack of start-up capital is the other constraints that moderately rated by the respondents ($M=3.77$, $SD=1.064$). Becker (2004) also identified that lack of working capital: credit has to be obtained from informal sources such as friends or relatives or non-banking financial agencies with unfavorable terms; insufficient funds do not allow for further investments were some of economic constraints. This result is in line with the result of Tambunan (2009) that inadequate capital and difficulties of finding start-up money through savings or loans is one of the constraints of informal economy.

4.3.4. Descriptive Measurement of transition intention of urban informal sector

Table 4.4. Transition intention of the respondent

Item	Categories	Frequency(f) N=320	Percentage (%)
Transition intention to formal sector	Yes	247	77.2
	No	73	22.8
	Total	320	100
If "yes" when you think to transfer?	Next year	22	9
	After 2 years	58	23.4
	After 4 years	111	45
	I didn't know the time	56	22.6
	Total	247	100

Source: survey data, 2017

The above table 4.4 shows the transition intention of the respondents from informal economy sector to formal economy or sectors. As the researcher understands from the above table that almost more than three fourth of wolkite and butajira urban informal economy participants have an intention to transform to the formal sector that 77.2 % of the respondent and the remaining 22.8 % of the respondent has not went to transform to the formal sector. The interview result also noted that many participants of the informal sector have expressed that they went to transform from informality to formality if they were given assistance, particularly with loans.

CONCLUSION

The factors that initiate or enforce the respondents to participate in urban informal sector are identified as cause to enter to urban informal economy. Among the identified reasons by the respondent are "Lack of enough capital to enter to formal sector," "Tight and unfair tax administration and regulations in the formal sector," "cannot fulfilled minimum requirements to operating in formal sector," "increasing unemployment" are the critical causes or reasons that enforce the urban informal economy participants. Based on this result the researchers can say urban informal sectors in Wolkite and Butajira urban areas a reason of informality are lack of enough capital to operate formally, seeking employment and unable to fulfill criteria of formal sector.

"High registration fee and procedure in the formal sector", "low entry requirements in terms of capital and professional qualifications in the informal sector" and "Lack of working place" are moderately ranked reasons. Among the reasons that have the lowest mean value were "It is the only source of income," "Complex government regulation for the formal sector," "Non competitiveness in formal sector," "Low salary payment in government jobs" and "the sector is highly profitable" that weekly enforce the urban informal economy

respondents to enter to this sector and considered as a less favorable reason.

The major constraints that face the urban informal economy participants during operating their business on informal sectors are lack of social protection and labor legislation at the workplace; inadequate regulatory policies and regulations to address unique informal sector problems; lack of safe nets in case of job loss, injury, sickness and death; difficulty of accessing finances due to lack micro credit and inadequacy of loans and absence of organized interest groups e.g. unions, associations to deal with government and solve the problems affecting the sector are highly ranked constraints or problems that faces on the participants of urban informal economy in Gurage zone Wolkite and Butajira urban areas.

The identified constraint or problem variables that moderately ranked by the respondent are lack of start-up capital, traffic incidence and police harassment and exposition to rain and sun during conducting their activity.

Customers perceive the products are low in terms of quality and price, lack of market network and working place, physical and verbal abuse especially for females, customers perceive the product is spoil, old or defective, inadequate skill and lack of training are weekly ranked problems by the respondents

More than three fourth of Wolkite and Butajira informal economy participants have an intention to transform to the formal sector that 77.2 % of the respondent and the remaining 22.8 % of the respondent has not went to transform to the formal sector.

RECOMMENDATION

- ✿ Gurage zone in general and Wolkite and Butajira urban government Administration in particular needs to compile a systematized data base and official statistics of the informal sector that will help policy implementation to design support programs, improvement of social and legal protection and be able to measure its contribution to the national economy.
- ✿ Even if many firms may not be formalizing because their own strategic reasons, the government shall make simplicity of business registration or licensing cost including simplified registration and licensing procedures to enhance the environment for businesses to operate formally.
- ✿ The government should make a tax reforms like equity in the tax system, providing tax-holidays for sometimes, build confidence in the taxing administration would impact the informal sector to bring them in to the formal sector especially for those small scale in terms of capital and operation and they are being informal only because of they fear high entrance tax to enter to formal sector.
- ✿ Shortage of working capital is the major constraints that the operators have indicated in the informal sector. In this respect, the policy makers need to design imperative measures to solve this hindrance factor, such as through providing access to microcredit and/or special credit services.
- ✿ Appropriate policy frameworks and strategies aimed at the informal economy should be developed that solve the problem of the sector without hampering the potential of the informal economy for job creation and economic growth thus develop innovative and supportive policies that recognize the contributions of the informal economy and its workforce.
- ✿ In order to attract the informal sector to formality and also improve the conditions of informal sector workers in Ethiopia and specifically in gurage zone, trade unions shall undertake legal protection-in advocacy and a campaign to secure a legislative framework that guarantees minimum standards for all workers, and campaign for the effective functioning of regulatory institutions to assure the application of labor standards.
- ✿ Even though the informal sector participants may have causes and advantages of remaining outside the formal economy, taxes and fees would be reciprocated by adequate service delivery from the part of government and access to proper and relevant institutions like banks and other financial institution. Therefore, the researcher recommend urban informal economy participants as much as possible shall use maximum potential to be register economy and formal.

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