

# **Informal Economy, Economic Growth and Poverty in Nigeria: A Macro-Economic Analysis**

**By**

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## **Abstract.**

The current global economic crisis is leading to a downturn revision of economic sizes worldwide. Nigeria like any of the Sub-Sahara economies is expected to witness reductions in the flow of private capital, as well as significant cut in aids flows and remittances. This might inadvertently lead to contraction in the size of the economy, as a result of close down of companies operations, downsizing of work force and/or production below capacity and lost of considerable revenue owing to reduction in demand for export. The foregoing translates to decline in economic growth vis-à-vis gross domestic product, thereby widening the inequality gap and poverty. In order to mitigate the effect of this adverse economic situation on the poor (who are the key players in the informal sector), there is the need to evolve a broad-base pro-poor growth through institutional and policy reforms that will not only expand economic opportunities, but empower the poor to gainfully participate in and measurably benefit from them. Strong public-private partnerships are needed to accelerate both the expansion of opportunities and the empowerment of the poor. Thus, it is necessary to analyze the critical path by which broad-based growth initiatives can lead to an expansion of GDP, and the resultant increase in savings resulting in poverty reduction through fiscal, financial and various other routes rather than focusing on pro-poor policies. One way of accompany this is re-enforcing informal credit institutions and capacity building. Since the poor are credit constrained, a well funded informal credit institution with good management will provide the needed fund for the poor to embark on sustainable income generating ventures and adequate training will trigger entrepreneurship spirit/effective management. Any policy/intervention approach that leads to increase in income, vis-a-vise savings of the poor has greater propensity to reduce poverty scale and dwarf the inequality gap.

## **Introduction**

The term “informal sector” refers to the part of the economy that does not fall under the purview of organized economic activities. It consists of very small enterprises that use low technology models and do not refer to legal status (Webster and Fiddler, 1996). Although dominantly, informal economic activities pertain to non-traded goods in the economy - from small retailers, street traders, vocational trade to domestic help. In Nigeria like many developing countries, they produce exportable and competitive import substitute goods either independently or in conjunction with the formal sector. In Nigeria like many developing and transition economies The informal sector has become an institution, in its own right generating with it various positive and negative implications effects . For instance, Davies (2006) argues that division of labour becomes greater than optimal in the presence of informal institutions, resulting in greater than optimal complexities and higher growth in the country.

On average, about 70% of the labour force in Nigeria belongs to the informal sector, while the urban informal sector ranges from 10 percent to 15 percent compared with 15 percent to 20 percent in Turkey, Slovakia to 80p percent in Zambia and about 83 percent in Myanmar (Marjit and Kar, 2007). More importantly, considering the state of agriculture and rural activities in Nigeria, it is quite obvious that the total share of the informal sector in the Nigeria economy as a whole would be very high (ILO,1999). This is re-enforced by the work of Turnham ( 1993), which provides evidence that in low income countries like Nigeria, Bangladesh, Ivory coast, India, the share of the whom informal sector to the overall economy is at least as high as 51 percent . Furthermore, the informal sector has subsequently emerged as an important institution due to competitive wage formation rather than unionized process which characterize formal labour market.

Looking at it from the point of view of “minimum wage” earners in the so-called informal sector, substantive employees in the sector earn less than the minimum wage, typically because of non market clearing downward rigid wages along with other corporate taxes push many private firms to operate in informal sector (Gang and Gangopadhyay 1990). A substantial portion of such employment opportunities is generated to provide means of livelihood to poor households. The majority of this workforce is economically marginalized with high poverty

incidence, exposure to difficult and hazardous working conditions, non-existence of social security or health benefit schemes other than poorly functioning state-provided medical facilities. Common features of operators in the informal sector include:

- Easier access to production factors which are derivable from social organisation of family and friends.
- Involves entrepreneurs in virtually all branches of the economy ranging from productive activities general services and specialized services.
- Technology is determined more by the constraints of the social relations.
- Motivation for production by the operators in the informal sector is becoming more profit oriented. (Ademu, 2006).

## **2.0 Informal Economy and Economic Crisis**

The current global economic crisis is leading to a downturn revision of economic sizes worldwide. Nigeria like any of the Sub-Sahara economies is expected to witness reductions in the flow of private capital, as well as significant cut in aids flows and remittances. This might inadvertently lead to contraction in the size of the economy, as a result of close down of companies operations, downsizing of work force and/or production below capacity and lost of considerable revenue owing to reduction in demand for export. How will all of this affect the informal economy and its contribution to the economic growth? In specific term, the current economic crisis has significant repercussion on the workforce in the informal sector, as workers employed in the informal sector are greatly affected by the economic crisis. Price increases that followed the crisis resulted in high cost of living, being poorer; they have fewer buffers available to them in the form savings and suffered from greater income uncertainty. The informal producers usually maintained a lower level of stocks and hence are also adversely affected by hike in input prices. However, the impacts of the crisis on the demand for informal sector products are ambiguous. On one hand, where the cheaper products produced by the informal sector are substitutes for the more expensive formal sector product, demand increases. On the other, where certain goods and services produced by the informal sector were considered to be non-essential (e.g handicraft products) with high income elasticities, demand will be expected to fall.

Equally important, is the direct impact of the economic crisis on the informal labour market. The workers who lost jobs in the formal sector entered the informal sector, increasing the competitiveness within the sector and reducing profit margin. Contrary to conventional belief, it is also witnessed in the recent time in the private sector, especially banks that despite economic prosperity declared by majority of the financial institution, they are entering into informal employment contracts where workers receive contractual tenures and wages with no access to various benefits that earlier generation of workers enjoyed. While this refers to informal practices within the formal institutions, a larger group of workers face more pervasive informalisation with enormous implications on aspects of income volatility, poverty and standard of living for all those inside and outside the informal segment.

The foregoing translates to decline in economic growth vis-à-vis gross domestic product, thereby widening the inequality gap and poverty. It has been argued by Ranis and Stewart (1999) and by Tokman (2001) that when economic growth rates decline, firms in the formal sector tend to contract by retrenching employees in order to reduce costs. This expected high level of unemployment will invariably lead to an expansion of the informal sector and the informal economy. Given the economic trends in the last two years in Nigeria, it is inconceivable that the size of the informal sector would shrink considerably below the existing level and therefore, sustained improvements in the living standards of these groups can only be brought about by capital accumulation, productivity gains, and income increases in this sector. But the extent to which the informal economy is able to offer productive engagement is not clear without adequate intervention and supports that will ensure that key players in the informal sector are empowered with requisite skills and finances that will enable them exploit their environment to earn sustainable livelihood.

While there may be several mechanisms that can generate such positive economic impact to the players in this sector, the argument here is that one crucial factors in this category is the degree of capital availability to the participants in the informal sector and the level of modern technological compliance skills (capacity building) that increase their competitiveness in spotlighting and exploiting business opportunities around them. The motivation behind invoking the issue of “easily accessible capital” and “capacity building” comes from the observation that the formal financial sector (both money and capital markets) of the Nigeria economy is presently

confronted with the credibility challenges. That is, people and corporate bodies have lost confidence in these institutions as a result of their failure to meet the expectations of the teeming populace in terms of provision of adequate credit facilities; mobilizing and pooling savings, producing information ex ante about possible investments and allocating capital; monitoring investments and exerting corporate governance; facilitating the trading, diversification and management of risks and facilitating the exchange of goods and services in the informal sector.

At present, six of the twenty consolidated banks have been adjudged unhealthy by the apex bank while the remaining fourteen classified as safe are hesitant to grant facilities to the poor households who are the key participants in the informal sector. Worst still is that the stock market {though not expected to provide capital for the poor or even small companies (Moss 2009) has crashed as a result of the global economic crisis. The only viable option for the poor to mobilize working capital for economic activities is through informal credit institutions and/or associations.

### **3. Informal Financial Institutions, Economic Growth and Poverty Reduction**

Informal Financial Institutions are institutions that embraced all financial transactions that take place beyond the functional scope of various countries' banking and other financial sector regulations. Aryeetey (1998), Chipeta and Mkandawavre (1991) saw them as financial institutions that are not directly amenable to control by key monetary and financial policy instruments. These institutions are usually created by organizations and individuals and with no legal status. According to Yusuf et al (2007), informal financial institutions can be classified into three namely:(i) proprietary informal financial entities, such as, money lenders, trader, estate owners, grain millers, smallholder farmers, self-help groups and other businessmen, (ii) staff and social welfare schemes such as those run by employers, friends relatives and neighbours; and (iii) mutual aid entities, such as, Accumulating Saving and Credit Associations (ASCRA) otherwise known as Cooperative Credit and Thrift Societies; and a Rotating Saving and Credit Associations (ROSCAs) (Chandavarkar 1985 cited in Aredo, 1993; Goodland et al. 1999). Rotating Saving and Credit Associations (ROSCAs) is known as *isusu* in Nigeria, *susu* in Ghana *ko* in Japan. World Bank (2004) defined informal institutions as associations whose members

regularly (e.g. weekly or monthly) contribute a fixed amount that is allocated to each member in turn (according to lottery, bidding or other system that the group establishes). Levine (1992) cited in Aredo (1993) saw this fixed contribution as an exchange for privilege of receiving a large sum at some point in the life of the group. Aredo (1993) inferred from these definitions, that in ROSCAs each member agrees to pay periodically a small sum into a common pool so that each, in rotation can receive one large sum. If a member's turn comes early, it is credit mechanism; if it comes late, it is a savings mechanism (i.e. early recipients realize a real net gain, those later a real net loss). The World Bank (1989) identified three types of ROSCAs: common ROSCAs, where the leader receives no special consideration (other than possibly getting the first fund); commission ROSCAs which pays their leaders and who in turn assume liability for defaults; and promotional ROSCAs which are used by merchants to sell their goods, especially consumable durables.

Analysing the theoretical importance of Rotating Saving and Credit Associations (ROSCAs), Steel and Aryeetey (1994) observed that they help in mobilizing saving through the people's daily collection of deposits, which are in turn used as working capital to restock supplies which enable them to expand their output and earn a stream of profits, thereby providing a significant source of income to individual household which reduces their level of poverty Zaman (1999) also observed that credit provided by ROSCAs could increase income and build assets. It increases income when the credit is used for an income-generating activity which brings returns in excess of the credit round payment, while it builds asset when the credit financed investment that does not generate a significant net profit but create an asset that serves as investment for the clients. Richardson and Lennon (2001) also reiterate that ROSCAs provides security for people through the saving facilities provided, thus safeguarding the people's money from incessant appeals from family and friends, while Miller and Northrip (2000) observed that ROSCAs also provide insurance facilities where small premiums are collected from which relatively large payments are made to clients that suffers losses from a specified risky event. Bolnick and Miltlin (1980) asserted that ROSCAs are also used by their clients to finance their finished houses, while Wilson (2001) observed that people join ROSCAs when they are faced by disaster, e.g. asset destruction from either flood or drought. Thus ROSCAs provide loan by allowing clients take loan early in anticipation of a disaster or by waiting until the end of the disaster to

salvage the situation. Brass and Henderson (2000) further said that ROSCAs are usually used by subsistence farmers to provide adequate storage facilities to protect their farm produce from seasonal price swing. This enables farmers to store their products in a reliable warehouse/store until prices are high thereby enabling farmers reap the rewards of high profit.

Examining the empirical importance of ROSCAs, the World Bank (1989) reported that in Bolivia, one-third to one-half of all adults living in urban areas often participated in ROSCAs which amounted on the average to about one-sixth of their salaries, and in rural Niger Republic about 398 village households in 1986 indicated that informal credits, most especially ROSCAs accounted for 84 percent of total loans they collect and was equal to 17 percent of their agricultural income. Goodland, et al. (1999) also observed that in Senegal, ROSCAs assisted in equitable distribution and utilization of local resources most especially income and raw materials because credit taken are used to finance income generating activity with returns in excess of the loan, thus reducing the level of poverty of the people. Dia (1996) also said that saving facilities provided by ROSCAs in Senegal are used for financing health care and education, thus increasing the people's access to these social facilities. The findings Akinrinola O and Mafimisebi T. (2009) also confirm that Cooperative Society is a pivot on which development of micro-business and vocational trades in both rural and urban informal sectors revolves. This was revealed in its enterprise financing, employment generation and wealth creation for members and non-members. Equally important, is the social integration and gender equality encouraged in the appointment of women into leadership positions in the executives of Cooperative Unions and its component cooperative societies.

As significant as the informal credit institutions are in facilitating economic activities, their capacity to fund investment opportunities in the economy is impaired owing to inadequate capital mobilization for its members, ineptitude on the part of their management to monitor investment and exerting corporate governance, dearth of requisite skills to facilitate diversification and management of risks and complete absence of technological know-how to facilitate transaction in the economy, both by physically providing the mechanisms to make and receive payment and by reducing transaction and information cost. Suffice to say therefore that any intervention aimed at promoting broad-based growth, stimulating economic activities and creating jobs in the informal sector necessarily needs to partner with these informal institutions as a mean of reaching the economically incapacitated entrepreneurs in the society.

In this present paper, an argument is advanced why mobilization of working capital through informal credit institutions is essential for understanding fully the implications of economic reform on the large informal sector in Nigeria and the paper tries to establish that comprehensive capacity building programme for the players in the informal sectors is *sine qua non* to economic development and poverty reduction in the Nigerian society.

#### **4 Macroeconomic Framework for Broad-Based Growth in Nigeria**

Pro-poor targeted expenditures directly serve the purpose of poverty reduction. In contrast, broad-based (shared) expenditures contribute to GNP growth first and then to poverty reduction by a way of increased savings, which channeled through fiscal resources or banks to particular uses targeted at poverty reduction (Aryeetey 2009). In Nigeria context, the conventional pro-poor policies that are infused in the basic policy package of property rights, fiscal discipline, macro stability and openness to trade to increase the income of the poor households (Klasen, 2001) seems not to have yielded the desired result. As the policy thrusts of government at various levels are not specifically targeted at the poor households.

Achieving pro-poor broad-based growth, would entail institutional and policy reforms that not only expand economic opportunities but also empower the poor (many of whom are engaged in the informal economy) to gainfully participate in and measurably benefit from them. Strong public-private partnerships are needed to accelerate both the expansion of opportunities and the empowerment of the poor.

Empowering the poor households through the informal credit institutions will require systematic understanding of the *modus operandi* of the activities of these institutions, their limitations/challenges, how to mainstream them into public-private partnership agenda. The purpose of such partnership is to design a workable channel through which funds can be transferred to the informal credit institutions in such a way that it will eliminate unnecessary transaction costs to the barest minimum, guarantee adequacy of fund for investment, bring credit source to the poor households and timely disbursement of fund to meet investment plans.

Considering the significance of the informal credit institutions in transforming the informal sector, the management of such institution though in the hands of elected members, should be closely monitored. Perhaps, institutional arrangement that will mandatorily make their activities accessible to government designated authority has to be put in place. This may be supported with adequate training of the executives of those institutions on the fundamentals of accounts and record keeping, investment appraisal, information management and retrieval and culture of transparency and accountability.

## **5. Approaches to support informal sector actors in order to foster growth and reduces poverty.**

### **a. Policy Options**

As markets fail to allocate resources more efficiently, it is important for policies to be formulated to deal with the problem of high unemployment; lawlessness and tax evasion that are often associated with the informal economy. There is the need to expand the economic participation of marginalized work-seekers and reduce economic uncertainty in poor people's lives.

Some policies are aimed directly at the specific issues, be it reducing barriers to entry and asset accumulation for small firms, or raising wages and work conditions for vulnerable workers. However, the overarching environment in which informal activities take place must be understood, or micro economic interventions will have less impact.

### **b. Fostering macro-economic stability as a precondition for economic reform, growth and informal sector development**

A sound and stable macroeconomic environment that enables economic growth, prevents high volatilities and dampens external and internal shocks not only stimulates the formalization of the informal sector, but also facilitates business activities in both the formal and the informal sectors. The dynamic of a sound and stable economic environment and increasing demands due to economic growth will also positively affect informal sector activities. The same is true for of a stable political environment and

public safety, since high rate of crime and violence disproportionately affect informal sector actors such as street vendors.

**c. Ensuring Private Property Rights for all Citizens, Clearly Defined and Strongly Enforced.**

Ensuring private property rights and legal security not only prepares the ground for formalising the informal sector. Secured, clearly defined and effectively enforced property rights greatly encourage any economic activity, also in the informal sector, and facilitate the conversion of private assets (dead capital) into productive capital. Without legally protected private property rights, entrepreneurs constantly face the risks of confiscation, forced relocation and harassment. In addition, they have few incentives to train personnel or purchase machines and other equipment in order to improve productivity and undertake larger-scale and longer-term investment. Insecure property rights also damage economic performance in other ways: obtaining water, electricity and telephone services usually requires a property title. The same is true for access to finance and banking. In addition, as the World Bank and Princeton study showed, ensuring property rights and legal security for poor people also had a positive impact on school enrolment rates, thereby promoting human capital-building and skills acquisition. Informal sector activities can also be supported by authorities applying more realistic land-use standards, and providing public land for enterprises and markets.

**d. Providing a minimal and well-maintained infrastructure essential for conducting any economic activity**

The provision of a minimal, well-maintained infrastructure of transport, telecommunications, water and power is essential for economic growth and the expansion of employment in the formal and informal sectors. Besides adopting more realistic land-use standards and providing public land for enterprises and markets, authorities could actively support the informal sector by developing a basic infrastructure for informal enterprises. The installation of electricity or water, for example, spurs productivity. The

same is true of transportation: a lack of access to transport discourages mobility, limits access to markets and to inputs for production and, therefore, affects productivity and profit margins in a negative way. In short, some of the measures for stimulating the informal sector's formalisation, presented in Section 2, also facilitate business activities in the informal sector. This holds for interventions at the macro-level – e.g. promoting economic stability and growth, ensuring property rights and legal security, and providing a functioning basic infrastructure – as well as at the micro-level – e.g. providing Business Development Services, access to micro-finance and skills training programmes. The strengthening of self-help grassroots organisations and informal entrepreneurs' associations both supports increasing public participation in the shaping of policy and lawmaking processes, which is the first step towards a formalisation of the informal sector, and provides an impetus for pursuing own interests and rights within the informal sector.

*.e.* **Provision of high quality, efficient, and cost-effective infrastructure essential for a democratic, market-based system so that entrepreneurs benefit from joining the formal sector.**

The provision of a high quality, efficient, cost-effective and well-maintained infrastructure of transport, telecommunications, water, and power is essential for economic growth and the expansion of employment. Improved public services and infrastructure increase productivity facilitate access to markets and, hence, provide an incentive for entrepreneurs to remain in, or to join, the formal sector economy. A fair amount of competition in these domains, through privatisation or transparent subcontracting bids with the government, greatly increases the efficiency, cost-effectiveness and quality of infrastructure provision. The key to facilitating informal sector's participation in the formal economy and in the policymaking and lawmaking processes is to institute democratic governance in the public and private sectors. This entails establishing mechanisms through which citizens can regularly voice their concerns and participate in policy and law making, monitor public and private sector activity and hold public and private sector actors accountable. Using such mechanisms, private sector associations and citizens can advocate for reforms that reduce business costs, and

encourage and facilitate participation in the formal economy. Such measures help to make both the public and private sectors more responsive to citizen's needs, increase efficiency, transparency, accountability and growth, and reduce corruption.

**f. Promotion of Informal-Formal Economy Linkages**

The informal economy directly or indirectly has linkages with the formal economy. When a conducive environment is created for firms in the informal economy to participate in linkages with firms in the formal economy, they stand to benefit from access to reliable market, financial support, technology transfer and training and supervision. However, majority of informal firms are excluded from these linkages. Measures which government may take to promote linkages include first, the reservation of significant percentage of public orders for those micro, small and medium enterprises (MSME) that comply with regulations. This in a way may encourage increased formalization of MSMEs. This can be done by increasing the number of suppliers and buyers linked to informal enterprises and excluding the middlemen who add no value to the transaction process, through establishment of regional market as being done in Sri Lanka and Ghana in the recent time (Becker, 2004).

**g. The Provision of Safety Net**

Participants in the informal economy enjoy little social protection against illness, disability, unemployment, old age or death of a main income earner. There must be a way of providing social safety nets for people working in the informal economy since they are more vulnerable to economic shocks than those in the formal sector.

**Conclusion**

Evidence suggests that the informal sector is very much a reality in Nigeria like any other developing economy as well as industrialized economy of the world. Evidence also suggests that in times of economic distress this sector works as a buffer and provides a livelihood for the impoverished masses even if the level might be somewhat inadequate. In a sense, the sector itself works as a type of safety net. In view of the role of the sector, leaving it unassisted in times of economic distress would be doing a grave injustice to a

large section of poor people who rather than depend on government support are brave enough to fight their way forward when faced by the unfavourable economic environment.

Given the level of high unemployment and growing poverty, as is the case in Nigeria, the informal economy is likely to expand and should be viewed more positively with a view to enhancing its productivity by removing institutional obstacles to the achievement of higher productivity. The informal economy has a role to play in generating incomes and wealth and the formal private market mechanism alone cannot be relied upon to solve the poverty and unemployment problems in Nigeria. If Nigeria is to make any significant progress toward achieving poverty reduction goals, policy must focus on informal economy strategies that encourage its participants to engage in the wider economy.

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