



## **The Informal Sector, Growth, Employment, and Sustainable Development**

### **Discussion Note**

## **The Informal Sector, Employment, and Structural Transformation**

### **Some Operational Recommendations for a Productive Policy**

#### ***Abstract :***

The significance of the informal sector in low income developing countries, particularly in Sub-Saharan African economies, makes it a priority issue that should be mainstreamed in the development agenda of the international community. Its implications in terms of productivity, competitiveness, regulatory framework, and quality of employment are critical elements for moving resources to more productive agricultural and industrial sectors as well as better integrating those economies into regional and international value chains.

This document draws on recent research in francophone Africa to examine the mechanisms through which the informal sector can improve job quality, tax collection, foreign investment influxes, and the transparency and magnitude of cross-border trade. Relevant policy actions are recommended at national, regional and international levels.

**Key questions for participants :**

1. What has been your country's experience in terms of contribution and obstacles of the informal sector to growth, jobs creation and sustainable development?
2. What are the major challenges and what policy/measures should be undertaken, at national, regional and international levels, to overcome these challenges?
3. In your view, how best can the G20 help address your concerns and in what way?

## Introduction

The informal sector matters because of its sheer size (for example about half of national output, more than 80% of total employment and 90% of new jobs in African low income countries), and its implications for economic development, notably its effects on employment opportunities, productivity, fiscal revenues, and growth. At the same time, gathering knowledge about the sector poses formidable challenges since, by definition, some or all aspects of informal economic activity are off the formal record. A fundamental debate involves the extent to which governments should seek to formalize informal firms through sanctions versus assisting these firms so as to increase their contributions to employment and income while they remain informal. On one hand the informal sector is a source of employment and incomes of last resort. For example, in Burkina Faso, monetary poverty incidence is 12 times higher for households deriving their income from the informal sector than for those engaging in formal activities (Benjamin and Mbaye, 2012a<sup>1</sup>). On the other hand, informality undermines development prospects through loss of fiscal revenues and unfair competition to formal firms. This creates an apparent tension between boosting the sector and shrinking it. A further important dimension, often overlooked, is that the informal sector is heterogeneous and policy should be differentiated accordingly.

Research on the informal sector in a number of regions points **to five main areas for policy interventions**. They are analysed in light of recent research work on the informal sector carried out in some African francophone countries.

### **1. Bring improvements to all levels of the informal sector continuum**

The informal sector consists of all activities operating outside the official legal and fiscal system, with a resulting lack of reliable statistical information. This definition encompasses considerable diversity and complexity of the informal actors in Africa, however. Many firms are micro-enterprises, whereas others are very large or part of national or even international networks. Some enterprises straddle the formal and informal sectors, and the distinction between formal and informal status can be viewed as a continuum rather than a sharp division (Benjamin and Mbaye 2012a, 2012b<sup>2</sup>; Steel and Snoggrass 2008<sup>3</sup>; Henley et al. 2006<sup>4</sup>). Many informal enterprises have a taxpayer ID number, and some maintain sub-contractual relations with multinational firms. Further, informality consists of a variety of characteristics, and firms should be classified along a spectrum, depending on the extent and number of characteristics of informality that they display. Policies should reflect this heterogeneity: at one extreme, the very largest firms that could easily formalize but choose not to should be sanctioned. At the other extreme, micro-enterprises require assistance in improving productivity. This heterogeneity should be further investigated along with policies targeted to differing types of firms, with a view to boosting productivity and employment.

**Actions:** Launch a research agenda and action plan to investigate and implement policies that assist small informal firms to improve productivity while enforcing fiscal and regulatory obligations for large informal actors.

### **2. Develop governance and public-private partnership for the implementation of mutually beneficial reforms**

The dualistic nature of most African economies, characterized by a large unregulated and untaxed informal sector, is an obstacle to sustained growth. The small formal sector - substantially consisting of foreign investment - must shoulder a disproportionate tax burden, severely hampering its competitiveness. Indeed, the informal sector provides almost no government revenue in Africa, despite accounting for more than half of GDP. N. Benjamin and A.A. Mbaye (2012a) reveal that for three West African countries, large formal enterprises contribute over 95 per cent of tax revenue,

while firms in the informal sector contribute less than 3 per cent - completely out of proportion to the informal sector's 50 per cent or greater share of total value added. This leads to a vicious circle, with increasing taxes and fees on a dwindling formal sector, as formal firms exit or become informal, and reduced foreign direct investment. Moreover, fiscal authorities harass formal firms. In West Africa, many formal sector managers complain that once they are identified by the fiscal authorities as significant taxpayers, they are subject to repeated audits and upward adjustments in payments (Benjamin and Mbaye 2012a). Recent literature emphasizes the role of 'tax morale' as a crucial determinant of the extent of tax evasion and in formalization more generally (Perry et al. 2007<sup>5</sup>). Tax morale refers to the perception of fairness and honesty of the tax system and of the government's appropriate use of these revenues. In Latin America, countries in which tax-payers are confident that their money has been put to good use have higher voluntary compliance with tax obligations. This conclusion is strongly corroborated by N. Benjamin and A.A. Mbaye (2012a) in West Africa, where the proportion of firm managers who express dissatisfaction with government use of tax revenues is very high, undoubtedly contributing further to tax evasion.

Research on the business climate in developing countries has come up with mixed conclusions regarding the effects of government interventions. On one hand, policies implemented by governments and intended to boost informal firms' productivity (training, cheaper credit) are considered necessary for private sector development. On the other hand, government is treated mainly as an impediment due to high tax collection and costs of compliance with regulations. A more sophisticated perspective on government is in order. Rules and enforcement are certainly important but so are the quality of public services, governance, perceptions of a level playing field, state failures, and many other institutional features that characterize "the system". For example, informal firms often complain as much about lack of transparency and difficulties of compliance with tax and regulatory obligations as the levels of taxation and regulatory requirements. Thus, governments and formal firms have a common interest in higher levels of tax compliance and better service delivery.

**Actions:** Launch public-private dialogues that reveal elements of a public-private bargain that enhances both public performance and private contributions to public finances. Such a dialogue toward this mutual need for reform must include actors from the informal economy and not be confined to constituents focused on defending the status quo.

### 3. Skills development and business services

Research indicates a strong relation between basic skills and labor outcomes, particularly in the informal sector, despite the sector's lower average returns. Nevertheless differences in access to education and other basic services between formal and informal actors are huge and lead to difference in skills, productivity and earnings. As many studies have found, there is a large productivity and earnings gap between formal and informal firms in Africa as elsewhere. For example, Roubeaud and Torelli<sup>6</sup> (2013) estimate that wages in the formal sector are twice higher than those in the informal sector in Cameroon and DRC, 3 times higher in Senegal, and 3.6 times in Côte d'Ivoire. In addition, when informality is differentiated along a continuum, the levels of formality and productivity are strongly and positively correlated, for numerous reasons. The informal sector relies on practices that hinder productivity growth, including lack of transparency or lack of knowledge of their own accounts, long-established traditions based on well-entrenched control of territory and rents, and sub-optimal allocation of productive factors (including reliance on family sources for credit). Informality also prevents companies from acquiring modern management skills and worker training, limiting growth potential and access to the world market. Low productivity may also lead to informal sector status through self-selection of firms by quality of management.

Boosting productivity of small informal firms is therefore a priority. Many of the programs recommended in the literature to increase the access of small informal firms to public services and

business training have been tried in Africa, with limited demonstrable success. Mostly, clear lessons from this experience are difficult to draw because few of the programs have been properly evaluated. Possibly, we need a better way to assess the success of these programs: rather than judge whether the programs are financially sustainable and if the businesses they support survive, we should determine whether they help reduce poverty, as well as provide training and skills that will improve outcomes for the people served. Further, these programs are the most useful for small household and micro-enterprises, i.e., those most likely to be employing the poor. Thus, targeted skills enhancement programs for small informal entrepreneurs and workers are effective means for increasing the contribution of the informal sector to inclusive growth.

**Actions:** Pursue the development of worker training and business service programs with a view to improving the capacity of vulnerable participants and improving the performance of the smallest firms along the continuum (as indicated above), but not necessarily with a view to formalizing or taxing them.

#### **4. Informal sector and cross-border trade : Reducing incentives for smuggling and make trade a tool for regional integration and development**

In West Africa, recorded intra-regional trade is small but smuggling is pervasive, despite regional integration schemes intended to promote official trade. Cross-border trade must be understood in the larger context of the overwhelming role of the informal sector in West Africa (Benjamin and Mbaye 2012a). Cross-border trade is closely connected to domestic wholesale-retail trade, which is dominated by the informal sector. Cross-border trade involves a complex interplay of formal and informal operators and practices. Ethnic and religious networks play a large role in organizing the informal sector, resulting in a set of shadow institutions that in some respects are more effective and powerful than official institutions (Golub and Hansen-Lewis 2012<sup>7</sup>; Benjamin, Golub and Mbaye 2014<sup>8</sup>). Informal trade can displace legal trade and otherwise undermine trade policy and the international competitiveness of developing countries. More research is needed to understand how informal trade affects the relations between developing countries and global supply networks, as well as how informal trade affects other informal economic activity, customs enforcement and border management.

Cross-border trade is a major source of income, employment and, paradoxically, government revenues for “entrepot” states, given that goods are imported legally prior to being re-exported illegally. This trade rests on a fragile foundation, however, and is unlikely to be conducive to long-term development given its dependence on the protectionist trade policies of its neighbors and its underground character.

**Actions:** Examine trade policies for provisions encouraging informal trade and pursue governance reforms, such as cross-checking between customs and fiscal authorities that can render trading networks more transparent while better integrating developing countries with the global economy. At the same time, the impact of informal trade on the incomes of impoverished border regions should be recognized, and alternative income sources should be considered. Regional integration initiatives should be mobilized to foster more regional policy coordination to avoid the kind of distortions that motivate smuggling between neighboring countries. Policy reforms should aim to diminish the incentives promoting illegal behavior - notably tariff and non-tariff barrier harmonization in the region - along with stronger state institutions, in this case customs administrations, that deter opportunistic behavior.

## 5. Turning the current demographic challenges into opportunity: better targeting of sectors of specialization and setting up a localized improved business environment

Booming urban informal sector reflects the failure of employment opportunities to match rapid population growth and rural-urban migration. Creating jobs for young people is now one of the biggest challenges facing African countries. In Niger, for example, annual population growth is about 4%, at which rate the population doubles every 17 to 18 years. Youth make up more than 65% of total labor force and are mostly either unemployed or underemployed, with only 2 - 8% finding jobs in the formal public and private sectors (Golub and Hayat, 2014<sup>9</sup>). These demographic trends put very strong pressures on living standards. Poverty rates are higher in the Sahel than in other African countries, with up to 80% of population living on under \$2 per day. Many developing countries have used their abundant labor supplies as the foundation for labor-intensive exports. A critical issue for Africa therefore is to boost labor demand through labor-intensive exports.

Labor demand in Africa lags due to a combination of lower productivity and relatively higher labor costs in Africa than in most developing countries. One reason is overvalued exchange rates pushing upward the dollar costs wage. The resulting elevated relative unit labor costs (ratio of dollar wage rate to productivity) depress competitiveness in manufacturing (Golub and Mbaye 2002<sup>10</sup>). Africa has a strong potential comparative advantage in labor-intensive light manufacturing and agriculture, including traditional primary products such as groundnuts and cotton and non-traditional products such as horticulture and fishing. Unfortunately, the adverse business climate and disorganization of production harms agriculture as well as industry, discouraging exports and foreign investment (Golub and Mbaye 2002; Mbaye 2005<sup>11</sup>; Golub and McManus 2008<sup>12</sup>). Improving competitiveness in agriculture and manufacturing is thus critical to stanching the ballooning growth of urban informal subsistence activities.

**Actions:** Governments must reduce obstacles to investment in unskilled-labor-intensive sectors and technologies in agriculture and industry. Donors, government, foreign investors and local entrepreneurs should work together to identify barriers to competitiveness. Successful examples such as specialty coffee exports in Rwanda and footwear in Ethiopia should be examined (Brenton et al 2009<sup>13</sup>; Dihn et al. 2012<sup>14</sup>) and efforts made to replicate or adapt them to country-specific circumstances.

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<sup>1</sup> Benjamin N., and A.A. Mbaye (2012a). 'The Informal Sector in Francophone Africa: Firm Size, Productivity and Institutions'. Washington, DC: World Bank.

<sup>2</sup> Benjamin N., and A.A. Mbaye (2012b). 'Informality, Productivity, and Enforcement in West Africa: A Firm-Level Analysis'. Review of Development Economics.

<sup>3</sup> Steel, W.F., and D. Snodgrass (2008). 'Raising Productivity and Reducing Risks of Household Enterprises: Diagnostic Methodology Framework'. World Bank Africa Region Analysis on the Informal Economy. Washington, DC: World Bank.

<sup>4</sup> Henley, Andrew & Arabsheibani, Reza & Carneiro, Francisco G., (2006). "On Defining and Measuring the Informal Sector," IZA Discussion Papers 2473, Institute for the Study of Labor (IZA) and World Bank Policy Research Working Paper 3866, March 2006.

<sup>5</sup> Perry G.E., W.F. Maloney, O.S. Arias, P. Fajnzylber, A. Mason, and J. Saavedra-Chanduvi (2007). 'Informality: Exit and Exclusion'. Washington, DC: The World Bank.

<sup>6</sup> Roubaud, Francois and Constance Torelli (2013), "Employment, Unemployment and Working Conditions in Urban Labor Markets of Sub-Saharan Africa: Main Stylized Facts," in Philippe de Vreyer and Francois Roubaud, eds, *Urban Labor Markets in Sub-Saharan Africa*, World Bank, pp. 37-80.

<sup>7</sup> Golub, S. and J. Hansen-Lewis (2012). 'Informal Trading Networks in West Africa: The Mourides of Senegal/The Gambia and the Yoruba of Benin/Nigeria'. In N. Benjamin, and A.A. Mbaye (eds), *The Informal Sector in Francophone Africa: Firm Size, Productivity, and Institutions*. Washington, DC: World Bank.

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<sup>8</sup> Benjamin N., S. Golub, and A. A. Mbaye (2014). 'Informality, Regional Integration and Smuggling in West Africa'. Forthcoming in *Borderland Studies*

<sup>9</sup> Golub, S. and Hayat, F. (2014). 'Employment, Unemployment and Underemployment in Africa.' WIDER Working Paper WP/2014/13.

<sup>10</sup> Golub, S.S. and A.A. Mbaye (2002). 'Obstacles and Opportunities for Senegal's International Competitiveness: Case Studies of the Peanut Oil, Fishing and Textile Industries'. World Bank Africa Region Working Paper 37. Washington, DC: World Bank.

<sup>11</sup> Mbaye, A.A. (2005). 'Sanitary and Phytosanitary Requirements and Developing Country Agro Food exports: An Assessment of the Senegalese Groundnut Sector'. World Bank Agriculture and Rural Development Discussion Paper. Washington, DC: World Bank.

<sup>12</sup> Golub, S.S. and J. McManus (2008). 'Horticulture Exports and African Development'. Paper prepared for UNCTAD. Mimeo.

<sup>13</sup> Brenton, P., R. Newfarmer, and P. Walkenhorst (2009). 'Avenues for Export Diversification: Issues for Low-Income Countries'. MPRA, Commission on Growth and Development Working Paper 47. Munich: MPRA.

<sup>14</sup> Dinh, H.T., V. Palmade, V. Chandra, and F. Cossar (2012). *Light Manufacturing in Africa: Targeted Policies to Enhance Private Investment and Jobs*. Washington, DC: World Bank.