NANYANG TECHNOLOGICAL UNIVERSITY SINGAPORE
NTU-SBF Centre for African Studies
Nanyang Business School

Africa Current Issues

Does Africa's Growing Informal Sector Threaten Economic Growth and Doing Business?

Vol. 2020 - 25

Does Africa's Growing Informal Sector Threaten Economic Growth and Doing Business?

Introduction

The International Labour Organization (ILO) released *Women and men in the informal economy: A statistical picture* on April 2020. This report presents new data on informal employment in Africa, set in the global context. The report reveals that informal labour dominates in Africa, and provides 85.8 per cent of employment. This compares to 68.6 per cent in the Arab States, 68.2 per cent in Asia and the Pacific, 40.0 per cent in the Americas and 25.1 per cent in Europe and Central Asia.

The new report also disaggregates the results across gender, providing new insights for development policy. It reveals that informal employment is a source of employment more often for men (63.0 per cent) than for women (58.1 per cent). Of the two billion workers engaged in informal employment worldwide, just over 740 million are women. In focusing on Africa, the report notes that women are more exposed to informal employment and more often found in the most vulnerable employment conditions.

Education level emerges as a key factor affecting engagement in informal employment in Africa. As the level of education increases, informal employment decreases. Those who have completed secondary and tertiary education are less likely to work in informal employment compared to those who completed primary education or less. Less than 30 per cent of workers with tertiary education are employed in the informal sector in Africa, compared to 93.8% of individuals with little or no education.

People living in rural areas are nearly twice as likely to be in informal employment as their urban counterparts. The agriculture sector has the highest level of informal employment – estimated at more than 90 per cent. However, rapid urbanization in many African countries over the past two decades has expanded the role of the services sector, which operates in the informal economy, to the point of now being the largest contributor to GDP in Africa. This leads to an interesting urban/rural divide for African employment patterns. While informal agricultural activities dominate in the rural areas, informal arrangements lead in growing urban service sectors.

As African policymakers seek to mobilize domestic resources to alleviate the swelling national debts burden, many see a need to reduce their debt servicing burdens by taxing the informal sector. This calls for a better understanding of the relationship between the informal (which is sometimes referred as the hidden sector) economy and the formal economy. One key question debated by African policymakers is whether informality represents an untapped driver of economic growth and fiscal revenue, or simply an attractive nuisance that distorts the formal economy and should be minimized or obliterated.

Touted as the fastest growing region in the world, Africa generated a 4.5% average annual growth rate over the past two decades. Some argue that this growth has been largely jobless. In fact, annual employment growth averaged about 3% over that period. Most new jobs were in the informal economy. World Bank enterprises data identifies competition from informal firms as a major obstacle cited by formal firms. Nearly two-thirds of firms in Africa claim to compete against informal firms, compared to 42.2 per cent, 41.1 per cent, and 47 per cent in Middle East & North Africa, South Asia, and OECD countries, respectively. What are the implications of this pattern for firms doing business in Africa? Are these patterns of informal employment causes or consequences of economic growth in Africa?

This article explores this phenomenon by investigating the role of informal employment on economic growth in Africa. The findings of our investigation are in three parts. First, we discuss the informal sector and its size in African economies. We will discuss informal employment and its determinants. We will disaggregate employment across gender, sector, and locations. Second, we will interpret data about the sector and its institutional arrangements to derive stylized facts about the informal sector in Africa. Last, we present evidence on the interactions among informality and economic growth, in the African business environment. The findings from this final stage provide a basis to derive the implications for policymakers, businesses, and civil society.

Measuring the informal sector in Africa

The term “Informality” describes the collection of firms, workers, and activities that operate outside legal and regulatory frameworks or outside the modern economy.[1] This informal (hidden or grey) economy is neither taxed nor monitored by any form of government. Economists use a variety of methods to estimate the size of this informal economy. Direct approaches based on surveys or samples rely on voluntary replies, tax auditing, or other compliance records to measure the informal economy. The results from this approach, as in many social science researches, are unlikely to capture all informal activities.

Indirect, or indicator, approaches use indirect information to estimate the size of the informal economy. For example, the discrepancy between the official and actual labour force approach states that a decline in labour force participation in the official economy can be seen as an indication of an increase in the size of the informal economy, if total labour force participation is assumed to be constant. Most direct and indirect methods rely on a single indicator for all effects of the informal economy.

In empirical studies of informality, the dominant method of estimating the size of the informal economy is the Multiple Indicator Multiple Causes (MIMIC) mode.[2] The MIMIC’s main features include: (i) the model explicitly considers multiple causes of the existence and growth of the informal economy, as well as multiple effects of the informal economy over time, whereas other methods mainly use one indicator of the size of informal economy (for example electricity consumption), and (ii) the model is based on unobserved variables, and thus considers a set of causes and indicators of the unobserved phenomenon to be measured.

The share of informal economic activity in Sub-Saharan Africa remains among the largest in the world, although this share is declining very gradually, as appears to be the case globally. The SSA unweighted average share of informality reached almost 38 per cent of GDP. This is surpassed only by Latin America, at 40 per cent of GDP and compares with 34 per cent of GDP in South Asia, and 23 per cent of GDP in Europe. In OECD countries, the informal sector is estimated to account for 17 per cent of GDP. Depending on the method used to estimate the size of the informal sector, Medina et al suggest that there is significant heterogeneity in the size of informality in SSA, ranging from a low of 20 to 25 per cent in Mauritius, South Africa and Namibia to a high of 50 to 65 per cent in Benin, Tanzania and Nigeria, as illustrated in Figure 1.[3]

Table 1: The informal sector in Africa

Country	Size of informal economy (% of GDP)
Mauritius	25
South Africa	26
Namibia	27
Cameroon	27
Botswana	28
Togo	28
Burundi	30
Comoros	30
Rwanda	32
Kenya	32
Niger	33
Burkina Faso	33
Malawi	34
Cote D'Ivoire	35
Zambia	36
Mozambique	36
DRC	37
Liberia	37
Guinea	38
Lesotho	38
Guinea Bissau	38
Madagascar	38
Ghana	39
Republic of Congo	40
Uganda	40
Mali	41
Senegal	42
Equatorial Guinea	43
Chad	43
Sierra Leone	44
CAR	47
Zimbabwe	48
Gabon	48
Angola	50
Benin	50
Tanzania	53
Nigeria	65
Sub Saharan Africa	**38**

Source: Medina et al, 2016[4]

Broadly, informality seems to fall with the level of income, likely reflecting higher government capacity and better incentives toward formality in higher income countries. It averages 40 per cent of GDP in low-income countries, whereas it only accounts for 32 per cent of GDP in emerging economies and 18 per cent of GDP in advanced economies. That global trait also holds for Sub-Saharan Africa, where the GDP share of the informal economy averages 40 per cent in the region's low-income countries and 35 per cent for its middle-income countries. Nonetheless, other variables are in play: oil exporters and fragile countries are, all else being equal, more likely to harbour informality, with GDP share well above 40 per cent of GDP.

There is a large variation in the share of informal employment among countries in sub-Saharan Africa (SSA). The share of informal employment reaches its highest level in Burkina Faso (94.6 per cent) and Benin (94.5 per cent). South Africa (34.0 per cent) and Cabo Verde (46.5 per cent) are among the countries in which informal employment has the lowest share.

Within sub-Saharan Africa, informality is the main employment mode in Central (91.0 per cent), Africa (91.6 per cent) and Western Africa (92.4 per cent). If agriculture is excluded, informal employment continues to dominate with a 78.8 per cent share in Central Africa, 76.6 per cent in Eastern Africa and 87.0 per cent in Western Africa. Southern Africa is the only sub region with less than half of its employed population in informal employment, at 40.2 per cent and 36.1 per cent excluding agriculture. In Southern Africa, employees represent 84.3 per cent of total employment compared to 40.4 per cent for Africa and 37.2 per cent for sub-Saharan Africa.

Stylized facts about the informal sector and obstacles to formalization in Africa

Much informality in Africa involves farming. This includes both subsistence agriculture and informal sales of marketable crops. A large share of employment involves self-employed sellers and peddlers living at near-subsistence levels.[5] Several methods are used to assess the size of the informal economy; we highlighted both the direct and indirect approach in the previous section. A less rigorous, but yet popular set of approaches used to estimate the size of the informal sector include: surveys of experts about their countries, such as those conducted by the Global Competitiveness Report; surveys of entrepreneurs about their own activities, such as the World Bank Enterprise Surveys; census counts of people reporting that they are self-employed, which is typically a good proxy for informality; and measures inferred from aggregate electricity consumption or lighting at night.[6]

The productivity of formal and informal firms can be inferred from the World Bank surveys for formal and informal businesses. First, informal firms—even those businesses surveyed by the World Bank—are much smaller than formal firms. The average formal firm employs 126 workers, while the average informal firm employs only four. Informal firms are also much less productive, when this is calculated as value added (sales net of expenditures on raw materials and energy) per employee. In the median sample country, informal firms add only 15 per cent of the value added per employee of formal firms (La Porta and Shleifer. 2014). The ratio of value added by informal firms to that added by formal firms ranges from 1 per cent in Congo to 70 per cent in Cape Verde.[7]

La Port, and Shleifer (2008) discuss the sources of productivity differences between formal and informal firms.[8] One interesting finding is that differences in the human capital of workers are small, as measured by education. One of the most striking differences between formal and informal firms is in the human capital of their managers. Using data from the World Bank Enterprise Surveys, we note that only seven per cent of the managers of informal firms have a college degree, while for formal firms, this is 76 per cent. Managerial human capital emerges as a quantitatively large and statistically significant determinant of productivity. Production function estimates imply nearly 30 per cent returns on each extra year of education for managers, even though estimated returns to an additional year of worker education fall in the standard range of six to seven per cent.

Why don't informal firms become formal? World Bank Enterprise Surveys of informal entrepreneurs enable a direct assessment of this question. Table 2 compares perceived obstacles to doing business reported by informal and formal entrepreneurs. By far the greatest perceived obstacle by both types of firms is lack of access to finance. 43.8% of informal firms mentioned access to finance as the most important obstacle against 18.5% of formal firms. Compared to perceived financing problems, government regulations are distant concerns. Fewer than 10 per cent of either formal or informal firms worry about each of the following: corruption; business licensing and permits; or the legal system. Lack of access to land is a bigger problem for informal firms, in part because a large fraction of them occupy their premises illegally and fear eviction.

Table 2: Obstacles faced by informal and formal firms in Africa

	Informal Enterprise Survey	Formal Enterprise Survey				
Obstacles (% of firms identifying an obstacle as the most important)		Small	Medium	Big	All	Formal vs. Informal
Access to financing	43.8	20.6	17.8	13.6	18.5	-25.3
Political instability	11.4	9.5	9.1	11.7	9.7	-1.7
Access to land	11.2	5.6	4.2	4.1	5	-6.3
Corruption	7.4	7.3	8.2	6	7.4	0
Electricity	7.3	10	9.8	7.4	9.8	2.5
Business licensing and permits	6.3	2.3	2.7	1.7	2.4	-3.9
Crime	3.4	5.2	5	7.2	5.4	2
Legal system	3.3	0.5	0.5	1.9	0.8	-2.5
Customs and trade regulations	2.1	3.2	4.4	5	3.8	1.8
Uneducated workforce	1.8	4.6	6	10.4	6	4.2
Labour regulations	1.8	2.6	3.1	4.8	3.3	1.4
Tax administration	0.1	4.3	6.7	6.4	5.3	5.2
Competitions from informal economy	0.1	14.4	13.4	9.9	12.9	12.9
Tax rates	0	7.7	6.2	6.3	6.8	6.8
Transportation	0	2.2	2.9	3.7	2.8	2.8

Source: La Port, and Shleifer (2008)

Economic growth and informality in Africa

The role of informality in economic development remains controversial. Pioneering authors such as Hernando De Soto (2000) view informality as an untapped reservoir of entrepreneurial energy, held back by government regulations.[9] They propose that countries unleash economic growth by reducing entry barriers or improving property rights regulations. Others such as the McKinsey Global Institute describe informality as parasitic, enabling informal firms to rely on their lower cost structures to compete unfairly against formal firms. They argue that informality should be suppressed, not unleashed.

On the other hand, La Porta and Shleifer (2014) argue that informality operates in a different universe than formal activities and therefore do not threaten formal firms.[10] The increase in firm value that the informal entrepreneurs or managers could realize by operating formally is too small to offset the additional costs from taxes and regulations. In this dual view, development comes from formal firms, and their expansion as the economy modernizes eventually dooms the informal economy.

The empirical evidence does not support De Soto (2000). Research finds that registration costs and knowledge of registration procedures are not particularly important for formalization of firms.[11,12,13] And despite the fact that informal firms believe that registration will increase their access to finance, impact evaluation studies suggest otherwise. For example, De Mel et al. (2012) find firms in Sri Lanka that formalize are no more likely to get a business bank account or a business loan.[14] In Bolivia, McKenzie and Sakho (2010) find no impact on the likelihood of a bank loan.[15]

Although La Porta and Shleifer (2014) may be correct in reporting that formal and informal firms operate in different universes, use of public goods by informal firms may create externalities that negatively affect formal firms. The informal sector often leads to distorted and insufficient economic growth.

Informality generates negative externalities that compound their adverse effects on growth. For example, informal activities use and congest public infrastructure without contributing tax revenue needed to replenish it. Since public infrastructure complements private capital in economic growth processes, a large informal sector implies smaller growth through this mechanism.

To answer the question posed earlier, informality is not in itself an obstacle to development, but rather a symptom of institutional deficiencies. Some authors hypothesize that the state's weakness in enforcing its own laws and regulations explains the development of the less-productive informal sector. As Kanbur (2009) points out, the main determinant of informality is the lack of application of the laws and regulations that govern business.[16] According to this author, the biggest challenge in addressing the question of informality is to understand why states fail to enforce rules they themselves decree. Kanbur adds that the state must only adopt those laws that it is capable of applying.

Conclusion and Implications

Informality is ubiquitous in Africa. The link between informality and growth is not straightforward. In some instances, the informal sector operates in a different universe and has no impacts on formal activities. This is often the case in the manufacturing sector where informal manufacturing activities produce (low-quality products destined for lower income consumers) different products for a different segment of the population while the formal sector produces for the export market. But there are sectors where formal activities depend on informal channels to reach their customers. Take the example of mobile airtime. Most African consumers buy their airtime from informal kiosks that are used as distributions unites by telecom companies. Informal activities may also compete against formal in the use of rival public goods such as roads as indicated earlier. But the negative relationship between the scale of the economy and the size of the informal sector cannot be ignored. It is clear that informal sector is partially a consequence of the limited opportunities generated by lacklustre economic growth.

Empirical observation reveals that efforts to reduce informality have little impact. Even the desire to increase the use of bank loans is insufficient motivation. It appears that simply promoting registration of firms generates neither greater productivity nor naturally occurring financial inclusion. Informality will prevail until development conditions emerge that cause firms to want to register.[17] Indeed, little genuine formalization will occur, and few benefits will accrue from formalization without such developmental improvements, especially in Africa.

To facilitate formalization, businesses and government should collaborate on long-term efforts to improve both the business environment and tax and other forms of compliance. Each sector can take actions that will improve the circumstances of the other. The public sector will have to improve public-expenditure management and the systematic enforcement of regulations. Firms that modernize can gain productivity and access to bank credit. These factors can lead directly to increased formalization. Both sectors have mutual interests in these reforms. Collaboration is more likely to succeed than a unilateral push to collect new tax revenues from the informal sector.

Author: Francis Mulangu

Editor: Dr. A. Lee Gilbert

Editor-in-chief: Prof. Sam Park

References

[1] De Soto, Hernando. 1989. The Other Path: The Invisible Revolution in the Third World. New York: Harper and Row.

[2] Schneider, F., and D. Enste, 2000, ―Shadow Economies: Size, Causes, and Consequences,‖ Journal of Economic Literature, Vol. 38, pp. 77-114

[3] Medina L, Jonelis, A, Cangul, M. 2016. The Informal Economy in Sub-Saharan Africa: Size and Determinants. IMF Working Paper 17/156

[4] ditto

[5] Banerjee, Abhijit V., and Esther Duflo. 2011. Poor Economics: A Radical Rethinking of the Way to Fight Global Poverty. New York: Public Affairs, Perseus Books

[6] Medina L, Jonelis, A, Cangul, M. 2016. The Informal Economy in Sub-Saharan Africa: Size and Determinants. IMF Working Paper 17/156

[7] ditto

[8] La Porta, Rafael, and Andrei Shleifer. 2008. "The Unofficial Economy and Economic Development." Brookings Papers on Economic Activity, Fall: 275–352.

[9] De Soto, Hernando. 2000. The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else. New York: Basic Books.

[10] La Porta, Rafael, and Andrei Shleifer. (2014). "Informality and Development." Journal of Economic Perspectives, 28(3): 109-126.

[11] De Andrade, G. Henrique, M. Bruhn, and D. McKenzie (2013). 'A Helping Hand or the Long Arm of the Law? Experimental Evidence on What Governments Can Do to Formalize Firms'. Policy Research Working Paper. Washington, DC: World Bank

[12] De Giorgi, G., and A. Rahman (2013). 'SME's Registration Evidence from an RCT in Bangladesh'. Economics Letters, 120(3): 573-78.

[13] Farazi, S. (2013). 'Informal Firms and Financial Inclusion: Status and Determinants'. World Bank Paper. Washington, DC: World Bank.

[14] De Mel, S., D. McKenzie, and C. Woodruff (2012). 'The Demand for, and Consequences of, Formalization among Informal Firms in Sri Lanka'. Policy Research Working Paper 5991. Washington, DC: World Bank.

[15] McKenzie, D., and Y.S. Sakho (2010). 'Does it Pay Firms to Register for Taxes? The Impact of Formality on Firm Profitability'. Journal of Development Economics, 91(1): 15-24.

[16] Kanbur, R. (2009). 'Conceptualizing Informality: Regulation and Enforcement'. Working Papers 2009/01. Ithaca: Cornell University

[17] Benjamin, N., and A. Mbaye. 2014. Informality, growth, and development in Africa. WIDER Working Paper 2014/052

NANYANG TECHNOLOGICAL UNIVERSITY SINGAPORE | NTU-SBF Centre for African Studies Nanyang Business School

NTU-SBF Centre for African Studies

The NTU-SBF Centre for African Studies (CAS) is to develop thought leadership and capacity for doing business in Africa. It includes bringing Africa to Southeast Asia and Singapore and helping Singapore to be positioned as the gateway into Southeast Asia. As such, CAS aims to build and expand its local and international profile by means of publications, conferences, seminars and business forums through collaboration with local businesses, other research entities and business schools in Singapore and Africa. http://www.nbs.ntu.edu.sg/Research/ResearchCentres/CAS

NANYANG TECHNOLOGICAL UNIVERSITY SINGAPORE | Nanyang Centre for Emerging Markets Nanyang Business School

Nanyang Centre for Emerging Markets

The Nanyang Centre for Emerging Markets (CEM) is a new initiative by Nanyang Business School to establish global thought leadership on business-related issues in emerging markets. It conducts research on pressing and timely business issues in emerging markets through a global research platform of leading scholars and institutional partners. It closely interacts with corporate partners to identify research topics and manage the research process. Its research outputs include valuable and relevant implications for sustained profitable growth for local and multinational companies in emerging markets. It delivers a variety of research reports and organizes forums, seminars, CEO roundtables, conferences, and executive training programmes for broad dissemination of its research outputs.
http://www.nbs.ntu.edu.sg/Research/ResearchCentres/CEM

Partner Organizations

Singapore Business Federation Apex Business Chamber · MTI Ministry of Trade and Industry Singapore · Enterprise Singapore · EDB Singapore

Indorama · Olam · PIL · Tolaram Group · Wilmar

Contact Information:
Que Boxi
Email: cas@ntu.edu.sg
Phone: +65 65138089
Address: S3-B1A-35 Nanyang Business School
Nanyang Technological University
50 Nanyang Avenue Singapore 639798