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Informality, growth, and development in Africa

Nancy Benjamin[1] and Ahmadou Aly Mbaye[2]

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Abstract: The informal sector makes up an overwhelming share of both gross domestic product and total employment in Africa. In this paper, we lay out some of the basic characteristics of the informal sector in sub-Saharan Africa, relevant institutions, and development issues. Proposed policy approaches recognize both that the great capacity of the informal sector is not easily harnessed into formal systems, and that development is problematic when the bulk of economic activity operates outside of the formal regulatory regime.

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[1] World Bank, nbenjamin@worldbank.org; [2] University Cheikh Anta Diop of Dakar (UCAD), mbayealy93@yahoo.fr

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1 Introduction

The informal sector is a major force in African economies, comprizing the majority of gross domestic product (GDP) and employment. And while informality does not lend itself to simple technical definition, we understand it as a multi-dimensional phenomenon, strongly influenced by local institutions, with the importance of different factors varying across the region. This paper lays out some of the basic characteristics of the informal sector in sub-Saharan Africa (SSA), relevant institutions, and development issues. Proposed policy approaches recognize both that the great capacity of the informal sector is not easily harnessed into formal systems, and that development is problematic when the bulk of economic activity operates outside of the formal regulatory regime.

This paper refers largely to the urban, non-agricultural informal economy. It develops several points that emerge specifically from the study of informality in Africa; the following are worth noting at the outset: 1) the dominant share of the informal sector in African economies to a degree that is greater than anywhere else; 2) the definition of informality as a continuum of characteristics; and 3) the importance of the heterogeneity among informal firms and the value of policy that promotes improvements beyond the dichotomy of formal and informal status.

2 Defining the informal sector: major approaches and potential limitations

Researchers studying the informal sector must first confront the lack of a single widely-accepted definition. Since the International Labour Organization's (ILO) groundbreaking 1972 report on informal activity in Kenya, researchers have created numerous definitions, and the chosen definition largely determines the sampling method used to gather data, as well as the conclusions and policy recommendations that follow. Kanbur (2009) rightly argues that any researcher studying the informal sector should begin by defining informality. Indeed, the lack of common definition of the informal sector is a prominent feature of the literature.

> Quite remarkably and unaccustomedly for our profession, the widespread discussion about informality is proceeding without an agreed-upon definition of the term. Even more astonishingly, the field seems to have reached agreement that informality means different things to different people. Empirical studies show only a limited degree of overlap between those workers classified as informal according to the various definitions. (Fields 2011).
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> Different countries and regions exhibit distinct patterns of informality. Because of this, generalizations about the causes and consequences of informal employment should be approached with caution… Just as informal activities exhibit enormous diversity, there is no single archetype of patterns of informality that fits all countries and regions. (Heintz 2012).

Lack of standard definitions and diversity in sampling strategies makes international comparisons of data on the informal sector almost impossible.

2.1 Characteristics of major approaches

An activity is not deemed informal as a function of its illicit or licit nature, rather according to the type of organization carrying out the activity. Both criminal and informal activities are hidden, but not to the same extent, and they are clearly not viewed with the same degree of disapprobation nor exposed to the same risk of prosecution. Several criteria are commonly used to define informality—size, registration, and social-security coverage for employees, being the most widespread. In his review of the most used criteria in the literature, Heintz (2012) puts on the top of his list of defining criteria: size that is meant to capture the scale of operations; registration status or recognition by a government agency, which is meant to indicate whether the enterprise would be subject to government regulation, employer/enterprise social-security contributions, and legal form of organization; and character (sincerity) of financial accounts.

In most studies of the informal sector, registration is used alongside with size to determine informal status. However, as Fox and Sohnesen (2013) point out, the majority of even-household enterprises are registered with some level of authorities. At the same time, firm size is usually measured by number of employees, whereas this can often be misleading given the large number of unreported informal workers at both formal and informal firms.

Benjamin and Mbaye (2012a) examine the securing of a bank loan as an indicator of formality. However, they find that informal firms largely satisfy financing needs from personal, family, or informal sources, which provide a better way for them to manage risks, and showed little interest in bank loans. Similarly, the Investment Climate Assessment (ICA) surveys in Africa find large shares of firms that qualify for bank loans, but that voluntarily exclude themselves from the formal financial sector.

The 15th International Conference of Labour Statisticians (ILO 1993) defines the informal sector as 'a group of household enterprises or unincorporated enterprises owned by households that includes: informal own-account enterprises, which may employ contributing family workers and employees on an occasional basis; and enterprises of informal employers, which employ one or more employees on a continuous basis.' The Organization for Economic Co-operation and Development (OECD) (1997) characterized the informal sector as those enterprises that either: a) do not have a legal work site, usually working instead out of private residencies, b) have a low level of capital investment, and c) are managed by family members either in total or in part. Similarly, Charmes (1993) uses three criteria when defining informal activities. Size of the activity is listed as the most important criterion, along with keeping of accounts, as well as registration and legal status. La Porta and Shleifer (2008) distinguish between two categories of informal firms: those that fail to register with tax authorities and other regulators, and those that are registered but understate revenues. They therefore observe that the registration criterion alone is not sufficient to qualify a firm as formal.

One underlying assumption of all these definitions is that informality is treated as synonymous with survivalist activities. While retaining the focus on micro and small businesses, Maloney's (2004) study on Latin America provides a more optimistic perspective on the informal sector, with individuals freely choosing to leave the formal sector to reap the benefits of informality. However, with the tiny private formal sectors in SSA, this flow from formal to informal employment has little relevance there.

2.2 Defining the informal sector as a continuum

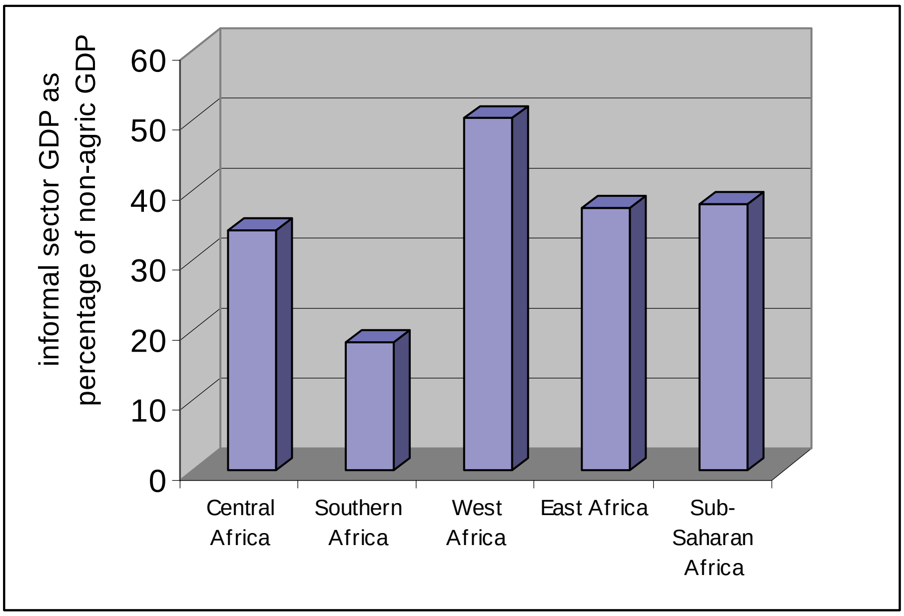
Given the several criteria used to describe the diverse facets of the informal sector, Benjamin and Mbaye (2012b) conclude that using a single criterion to define the informal sector can be misleading, and suggest that informality is better described as a continuum defined by a combination of the above criteria, with some enterprises more closely resembling formal firms and others more completely informal. By the same token, Steel and Snodgrass (2008) note, '…There is a continuum of different degrees of formality (in terms of different characteristics such as nature of registration, payment of taxes, management structure, contractual arrangements with employees, market orientation, etc.' Similarly, the ILO (2002) acknowledges the great heterogeneity of the informal sector. They suggest that there are degrees of formality and informality along a continuum rather than mutually distinct sectors.

Henley et al. (2006) investigate the degree of congruence between their three definitions of informality based on employment-contract registration, social-security protection, and the characteristics of the employer and employment using Brazilian household-survey data for the period 1992-2001. They find very little overlap between firms classified as informal using different criteria. Moreover, their results suggest growing heterogeneity within the informal sector. While such heterogeneity of the informal sector is supported by a growing body of literature, most empirical studies of the informal sector classify firms as either formal or informal; Benjamin and Mbaye (2012a) is a notable exception.

3 The informal sector in Africa: size, structure, and institutional context

In Africa, informal firms provide a significant share of value-added and the vast majority of employment. Inevitably, estimates of the size of the informal sector reflect the definitions of informality. Even so, without question, the informal sector is at the forefront of African economies and will continue to grow. Studies conducted across a wide distribution of African countries lead to estimates that the informal economy accounts for 50-80 per cent of GDP, 60-80 per cent of employment, and as much as 90 per cent of new jobs. Some of the largest and fastest growing sectors of West African economies are dominated by informal firms: wholesale and retail trade, transportation, restaurants, reproduction of CDs and tapes, carpentry, construction, real estate, etc.

Figure 1: Contribution of informal sector to non-agricultural GDP in African regions



Source: Authors' calculation based on data from ILO (2002).

Note: The percentages shown are regional averages for countries where data are available. The countries are Central Africa (Cameroon, Chad, and Gabon); Southern Africa (Botswana, Mozambique, South Africa, and Zambia); West Africa (Benin, Burkina Faso, Cote d'Ivoire, Ghana, Guinea, Guinea Bissau, Niger, Senegal, and Togo); and East Africa (Burundi, Kenya, and Tanzania).

Table 1: Informal sector as a share of non-agricultural employment in selected African countries

Country	Year	Share (per cent)
Benin	1993	93
Burkina Faso	1992	77
Chad	1993	74
Kenya	1999	72
Mali	1989	79
Mozambique	1994	74
Senegal	1991	76
South Africa	1995	19
Zambia	1998	58
Sub-Saharan Africa	-	*77*

Source: Charmes (2002).

In the developing world, the majority of informal agents are small-size firms: self-employment represents 62 per cent of total informal employment in North Africa, 70 per cent in SSA, and 81 per cent in SSA, excluding South Africa (Becker 2004). Another characteristic of the informal sector is a strong female presence: In SSA, 84 per cent of employed women are in the informal sector. Fox and Sohnesen (2013) find that the largest category of non-farm employment are household enterprises, and that this sector is growing due to limited alternatives for those who lack education or access to markets because of remote locations.

Yet the informal sector is heterogeneous, including some large or network operators, as studies of SSA confirm. While the vast majority of informal firms are very small, Benjamin and Mbaye (2012b) find that large informal firms play a major role in West Africa. A firm that chooses to be informal in a country with weak regulatory enforcement can grow quite large. Corruption in all rungs of society contributes to the flourishing of large informal actors. Often, they are well connected politically, which offers them some impunity.

As in other regions, informal firms show lower productivity than formal firms. Among the outcomes of informality, the productivity issue is critical. As many studies have found (discussed below), there is a large productivity gap between formal and informal firms. Results from Gelb et al. (2009) confirm the same result for southern and eastern Africa, and Benjamin and Mbaye (2012a) corroborate this fact in francophone West Africa. In addition, when informality is broken down into different degrees along a continuum, the level of formality and productivity are strongly and positively correlated.

3.1 Informal firms and taxes

Informal firms—while mostly registered somewhere, and mostly paying some taxes—pay a far lower share of taxes, given the total size of their activities, than do formal firms. Recent literature, (Perry et al. 2007) emphasizes the role of 'tax morale' as a crucial determinant of the extent of tax evasion and informalization more generally. 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 Benjamin and Mbaye (2012a) in West Africa, where the proportion of firm managers, who express dissatisfaction with government use of tax revenues is very high.

Perhaps for this reason and probably for many others, tax evasion in the informal sector is pervasive. There is a gaping disparity in the respective shares of GDP of the formal and informal sectors and their contributions to fiscal revenue. Indeed, the informal sector provides almost no government revenue despite accounting for more than half of GDP. Benjamin and 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 three per cent—completely out of proportion to the informal sector's 50 per cent or greater share of total value-added. Governments have attempted to devise taxes on small informal firms, mainly through the lump-sum presumptive tax, but outcomes so far have been very disappointing. Large informal firms are capable of paying far more than they do, but are able to evade their responsibilities due to under-reporting and political clout.

3.2 State failures and informal sector

State failures, a common factor in informality, have a unique nature and importance in Africa. The informal sector is in part a symptom of institutional deficiencies, and the large informal sector, in particular, is a symptom of government failure to enforce regulations that should apply to these firms, as well as the burdensome nature of regulations and taxation that inhibits compliance. State failures are often identified as a central factor contributing to the spread of the informal sector in developing countries. Recent literature views informality as a rational choice in response to costs and benefits of formal versus informal status, e.g. Perry et al. (2007), Kanbur (2009), Djankov et al. (2002), Loayza et al. (2005), Ishengoma and Kappel (2006), Arterido et al. (2007), and Marcouiller and Young (1995). The institutional environment heavily conditions this choice. Formalization means greater access to public services, but also requires compliance with regulations and payment of taxes. The extent to which the government enforces rules and sanctions non-compliance is also critical. A number of studies have corroborated the importance of these considerations.

Gelb et al. (2009) refine this view: they argue that the quality of the regulatory framework, along with the state's capacity to enforce regulations, is vital in determining a firm's decision to join the informal sector. According to them, it is important to distinguish between two scenarios: a) educated individuals managing productive informal firms that have a high potential for growth, in which case improving the regulatory framework and access to services might lead them to formalize; b) an adequate regulatory framework is already in place and the only firms in the informal sector are those that are practicing survival strategies. In the second scenario, helping firms to access social services would, at best, enable them to survive. Kanbur (2009) argues that a key determinant of informality is the lack of enforcement of regulations.

Benjamin and Mbaye (2012a) find that government policies and institutions, and their failures, shape the informal sector in West African countries. All of the following contribute to informal sector growth: the length and complexity of registration procedures; the failings of the judicial system; the inadequacy of organizations charged with recovering loans and providing support to small enterprises (informal enterprises in particular); and the ability of large and influential actors—often with the government's help—to by-pass regulations. In this set of countries, informal activity is pervasive. Given governments' limited monitoring and enforcement capabilities, and widespread corruption, informal enterprises can easily conceal their activities and evade taxes. Firms simply do not list certain activities in their accounting, present falsified financial statements, import goods under multiple fiscal identification numbers, or smuggle outright. They conclude that the observed weak enforcement of business regulations is partly a matter of low capacity, but can also be due to low public ownership of regulations.

While the shortcomings of domestic tax systems are discussed above, the failings of the customs systems are closely related to the large involvement of the informal sector in cross-border trade. In West Africa, recorded intra-regional trade is small, but unrecorded trade is pervasive. Cross-border trade is closely connected to domestic wholesale-retail trade, which is dominated by the informal sector. In keeping with the notion of informality as a continuum rather than a dichotomy, many firms straddle the formal and informal sectors, and almost no firms are totally formal (Benjamin et al. 2012a). 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). Large informal firms and kinship networks, spanning the artificial borders of nation-states, play a particularly prominent role in cross-border trade.

4 Informal employment

Informal employment generally lacks social-security coverage, affiliation to labour organizations and written contracts, and often includes unstable working conditions, as well as illegal or quasi-legal work. Informal employment refers primarily to employment in enterprises that lack registration and social-security coverage for their employees (OECD 2009). These include casual day labourers, domestic workers, industrial outworkers, undeclared workers, and part-time or temporary workers without secure contracts, worker benefits, or social protection.

Clearly, most studies on the informal sector in Africa conclude that its workforce differs substantially from that of the formal sector. Self-employment is a predominant characteristic; a study led in Botswana, Kenya, Malawi, and Zimbabwe shows that about two-thirds of informal firms in these countries consist only of the owner (Haan 2006). Another important characteristic of the informal labour market is its strong gender bias: a high proportion of women in the active labour force in the developing world are in the informal sector. In SSA, this share is even higher (Steel and Snodgrass 2008; CSO 2008). According to Chen et al. (2005), women are concentrated in the more precarious types of informal employment, and the average earnings from these types of informal employment are too low, in the absence of other sources of income, to raise households out of poverty.

Another feature of informal employment in Africa is its high share and the magnitude of its growth rates. Fox and Sohnesen (2013), in a study covering Burkina Faso, Cameroon, Republic of Congo, Ghana, Mozambique, Rwanda, Tanzania, and Uganda, estimate that wage and salary employment in private non-agricultural enterprises is still rare in SSA; this sector on average accounts for only nine per cent of the employed population. The largest category of non-farm employment is household enterprises. According to Fox et al. (2013) private non-agricultural wage jobs are unlikely to become a large share of employment in the foreseeable future; the number of people entering the labour force will swamp the capability of the formal private sector to respond, especially given the demographic youth bulge. For the rural and less-educated, the only opportunity to access the non-farm sector is through the creation and development of household-enterprise employment.

4.1 Informality and earnings

There are substantial earnings differential between formal entrepreneurs and formal wage-earners, as well as between informal entrepreneurs and informal earners, whose earnings are quite low. The earnings differentials between formal and informal actors are widely documented across countries and geographical regions (Gasparini and Tornarolli 2007), and confirmed in Africa by Benjamin and Mbaye (2012a). In their report on the progress of world's women, Chen et al. (2005) observe that no trickle-down effects stemming from improved development indicators for the world's emerging economies have benefitted the informal sector. They note: 'Increasingly, rather than informal work becoming formalized as economies grow, work is moving from formal to informal, from regulated to unregulated, and workers lose job security as well as medical and other benefits.' The report concludes that unless efforts are made to create decent work for the global informal workforce, the world will not be able to eliminate poverty or achieve gender equality.

What we observe is a clear pattern whereby difference in access to education and to other basic services lead to difference in skills, productivity, and earnings. La Porta and Schleifer (2008), Haan (2006), and Gelb et al. (2009) found substantially lower education levels among the informal sector. In his study of South Africa, Braude (2005) found a huge discrepancy between informal sector and formal sector actors' levels of education, in favour of the latter, and similar discrepancies in earnings between the two categories of workers.

4.2 Rural-urban migration and the informal sector

Rural-urban migration is one of the most important determinants of the rise of informal labour force in the developing world. Becker (2004) documents the magnitudes of such internal migration trends in developing countries and finds them to be astonishingly high in some instances. For Africa, Kessides (2005) finds that urban-population growth has almost doubled in 15 years, mostly due to such migrations. 'Despite the existence of positive marginal products in agriculture and significant levels of urban unemployment, rural-urban labour migration not only continues to exist, but indeed, appears to be accelerating.' (Harris and Todaro 1970).

In the classic Harris and Todaro (1970) model, the informal sector is the main refuge for the urban unemployed and the host of the newly arriving rural migrants on their way to the formal-sector jobs. Using an improved version of the same model, Bhattacharya (2002) emphasizes: 'the informal sector is not primarily a transit camp for disappointed migrants queuing for formal sector jobs, but a dynamic sector making substantial contributions to income and output, capable of attracting and sustaining labour in its own rights'.

Empirical evidence on Africa is rather mitigated and only partially lends support to the Harris-Todaro model. Huge disparities in access to basic services (education, health, and other infrastructural services), as well as low earnings opportunities, seem to be the most important drivers of rural-urban migration in the Africa region. But there seems to be little evidence that immigrants are more disadvantaged than city dwellers in finding formal-sector jobs. Using household-survey data from South Africa, Cornwell and Inder (2004) confirm that compared to job seeking non-migrants, recent migrants are not disadvantaged at finding formal employment jobs, and are much less likely to be unemployed. Likewise, Piché and Zourkaleini (2007) reach the same conclusion with data from Burkina Faso. Asfaha and Jooste (2006) find that rural-urban migration occurs where there is economic disparity between rural and urban areas. Using data from South Africa, they find that narrowing the urban-rural income differentials can reduce the massive rural-urban migration and high urban unemployment in the country. It is further shown that developing agricultural land and infrastructure, and increasing the use of fertilizers can boost agricultural income, reduce rural-urban migration, and is consistent with policies aimed at curbing urban unemployment. However, urban employment probabilities are still better than rural for many of these people. De Haan et al. (2003) find that distribution of land and other assets affect out-migration and are good determinants of rural-urban migration.

5 Four main questions

5.1 Why is informality so pervasive?

Household surveys in Tanzania and Republic of Congo asked household-enterprise owners to report their main reason for starting a business and found that push factors dominated the list. Not being able to find a wage and salary job was the most frequently cited reason.

Daniels (2003) uses panel data from Zimbabwe from the 1990s to show that the number of labour-intensive micro and small non-agricultural enterprises (MSEs) rose during bad economic times, and fell as economic conditions improved. Similarly she finds that entry into labour-intensive MSEs in rural areas is negatively correlated with agricultural income. Her results imply a 'survivalist' model of MSE creation. These results are complemented in Daniels (1998) that among MSEs providing the sole source of income for the household, 72 per cent in the urban areas earn less than the absolute poverty line. Otsuka and Yamano (2006) report that shocks to crop production lead to increases in labour supply to casual wage labour and self-employed artisans.

Calvès and Schoumaker (2004) found, using the database of surveys from Burkina Faso, that following the application of structural adjustment programmes in this country, the labour market made an unprecedented move to the informal sector. Golub and Mbaye (2002), and Lindauer and Velenchik (2002) revealed these same tendencies in Senegal. In spite of the steady GDP growth at an average of five per cent, enormous job losses were recorded in the industrial sector. These losses were mostly absorbed by the informal sector, whose size did not cease to grow in the same period. Lindauer and Velenchik (2002) estimate that the proportion of industrial jobs out of total jobs fell from 12.3 to 8.6 per cent between 1994-2001.

Government-enforcement capabilities, the quality of the business environment, and access to public services are found to be major determinants of firms' decisions on informality. Firms choose to be informal based on the set of regulations and institutions facing them—and on government's ability to enforce the regulations. However, firms—both formal and informal—need relationships of trust in order to secure inputs, get credits, and market their products. These relationships are supported in principle by formal institutions, such as legal and judicial systems. In practice, however, these institutions generally function poorly in African economies and official institutional support for property rights is almost completely absent. Firms can, to some extent, internalize these relationships of trust if they are large enough. Taken together, these two aspects help to explain both the pervasiveness of informality, as well as the existence and persistence of large, informal sector firms in West Africa. In addition, they are consistent with the prevalence of informal religious and ethnic networks, which can substitute for official institutions that should support arms-length trading in the formal sector (Golub and Hansen-Lewis 2012).

5.2 Why are informal firms less productive than formal firms?

Productivity is critical to growth dynamics, and a large literature shows that there is a strong negative correlation between informality and productivity of firms in developing countries. Factors explaining such a divide are very diverse. Steel and Snodgrass (2008) find that the productivity differential between the two categories of firms is due mainly to unequal access to public services. Gelb et al. (2009) point to the quality of the business environment and the enforcement of rules. The relative weakness of the state in the eastern African countries included in their sample is found to undermine the performance of formal firms, thereby lowering the gap between formal and informal firm productivity. That is, the benefits of formalization are low in terms of productivity differentials if business services are of poor quality, or if informal operators can evade taxes and regulations.

La Porta and Shleifer (2008) find complementary results using World Bank's informal surveys. They find the biggest explanatory factors of the productivity gap between formal and informal firms to be expenditure on inputs, human capital of the top manager, and size which, once controlled for, leave little impact on productivity from the sole fact of being unregistered.

Low productivity may lead to informal-sector status through self-selection of firms by quality of management. Reverse causation running from firm status to productivity could be due to the reduced access to public services that informality entails. Benjamin and Mbaye (2012a) investigate productivity differentials between large and small informal firms in West Africa. The results indicate that large informal firms also have lower productivity than formal firms, but the differential is minor, whereas the productivity gap between large and small informal firms is much greater. They find a fairly clear negative correlation between the firms' informality and their productivity levels. This result confirms the thesis of Gelb et al. (2009) in which the weakness of regulations drives many firms, with a strong potential to grow, to remain in refuge in the informal sector, reducing the productivity gap between the formal and informal sectors.

Benjamin and Mbaye (2012a) also examine total factor productivity (TFP) in addition to labour productivity. TFP controls for capital intensity, yet they find the same positive correlation between TFP and formality as for labour productivity. This shows that capital intensity alone cannot explain differences in labour productivity. Large informal firms, in particular, are like a giant with feet of clay. They manage large volumes of value-added and temporary workers, but they are run like a family firm with a small number of permanent employees, no specialized departments, and seldom survive the death of the owner, or a rupture with political protectors. The informal sector relies on practices that hinder productivity growth. Their lower productivity may be influenced by the fragility noted above, 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.

5.3 Is it best for development to push head-on to get informal firms to register and pay formal taxes?

Informal firms constitute a tantalizing subject for development study. In Africa, informal firms provide about half of value-added and the vast majority of employment. However, as in other regions, informal firms show lower productivity than formal firms. And informal firms, while mostly registered somewhere or otherwise known to the authorities, and mostly paying some taxes or fees, pay a far lower share of taxes, given the total size of their activities, than do formal firms. For this and other reasons, informal firms provoke substantial complaints from the formal sector claiming unfair competition.

Many would like to capture the added potential productivity and the added public revenues that appear to be possible when bringing informal firms into the formal sector. Various research projects have been field-tested in a variety of ways in order to reduce the costs or increase the understanding of procedures for formal registration of informal firms. However, the results have been mostly negative, with informal firms remaining uninterested in registration.

For example, recent research has highlighted that registration costs and knowledge of registration procedures are not particularly important for formalization of firms (De Andrade et al. 2013; De Giorgi and Rahman 2013; Farazi 2013). And despite the fact that informal firms think that registering will increase their access to finance, there is some evidence from impact evaluation studies that suggests otherwise. For example in Sri Lanka, De Mel et al. (2012) find firms which formalize are not any more likely to get a business bank account or a business loan. In Bolivia, McKenzie and Sakho (2010) find no impact on the likelihood of a bank loan.

Several studies illustrate the productivity of an approach focusing on regulatory improvements to the institutional environment as a path to policy that takes account of the informal sector. According to Steel and Snodgrass (2008), policy should focus less on legalizing the informal sector than creating a level playing field for agents of the formal and informal sectors.

La Porta and Schleifer (2008) argue for a focus on formalization, but Perry et al. (2007) found that to be efficient, such measures should go in tandem with a substantial rise in the advantages tied to the formal sector, especially access to credit and training, the implementation of procurement rules guaranteeing all access to markets, the development of programmes encouraging trade connection between small and large businesses, legal assistance to small firms; thus a policy mix combining encouragement and punishment, or a carrot-and-stick tactic.

Gatti and Honorati (2008) analyse data from 40 countries. They conclude that, ' …policies directed at improving the functioning of capital markets are unlikely to be fully successful unless they are complemented by policies—such as increased enforcement and simplification of tax codes—aimed at decreasing the level of informality and improving transparency.'

5.4 What is the best thing to do to help informal firms and those employed in the informal sector?

A hostile business climate can be a major source of the growth of the informal sector. In this case the informal sector is not in itself an obstacle to development, but rather a symptom of institutional deficiencies. Some authors estimate that it is the state's weakness in enforcing its own laws and regulations that explains the development of the less-productive informal sector. In Kanbur (2009), the main determinant of informality is the lack of application of the laws and regulations that govern business. According to him, the biggest challenge in addressing the question of informality is to understand why states are bad at enforcing the rules that they themselves decreed. He adds that the state must only adopt laws that it is capable of applying.

A key conclusion from studies in Africa is that policy recommendations are likely to differ between large and small informal enterprises. For large or more sophisticated informal firms, the goal must be to bring them under the formal-regulation net and register them for formal-tax regimes. For small informal firms, the policy implications are already quite well known: programmes to raise the ability of micro-enterprises to reduce poverty, often by supplying training, credit, and business-development services, must be instituted or expanded.

Many of the programmes 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 programmes have been properly evaluated. (World Bank 2007; and Yoshino et al. 2012 are notable exceptions.) Possibly, we need a better way to judge the success of these programmes: rather than judge whether the programmes are financially sustainable and if the businesses they support survive, we should judge whether they help reduce poverty, as well as provide training and skills that will improve outcomes for the people served.

For the large informal firms with a genuine choice, policy should be oriented toward a more systematically enforced and enforceable regulatory regime, especially given the weak institutions in African countries. Governments should systematically test regulations for their social-benefit content, and explicitly consider the cost of compliance for firms and the requirements of systematic enforcement for government, along with the cost to credibility of irregular enforcement.

While firms benefit from better public services and regulatory regimes, and governments benefit from increased revenues for services and enforcement, both firms and government serve each other poorly in these respects, contributing to a low growth trap of poor institutions. Benjamin and Mbaye (2012a) recommend that policy should distinguish between large and small informal firms, and further that firms and government should collaborate on an effort to improve both the business environment and tax compliance, in recognition that each side provides essential means for working out of the trap, and securing better institutions and development.

Government can and should move independently to improve public-expenditure management and results-based management. And firms can gain in productivity and access to bank credit if they maintain sincere and transparent accounts, and pay formal taxes. However, firms prefer to pay taxes when they know others like themselves will also pay, and the business climate especially needs a systematic enforcement of regulations, which requires public intervention. This mutual interest in reforms should be exploited, and such collaboration is more likely to succeed than a unilateral push for new tax revenues from the informal sector.

6 Conclusion: what is a good approach to development that takes the existence of the informal sector into account?

Research on SSA confirms the heterogeneity of the informal sector, and the importance of distinguishing the large from the small informal firms, in describing behaviour and identifying obstacles in the investment climate. In most studies, the larger or more formal-like informal firms are assumed not to exist or are excluded by definition from informal-sector data. Yet this heterogeneity is essential for policy development. We find that the most productive approach involves differentiating policy between the larger or more sophisticated informal firms, and the smaller subsistence firms. For example, regulatory enforcement should focus on larger informal firms rather than small firms, so as to avoid worsening poverty and unemployment.

For small informal-sector firms the goal of policy is to assist them, while inducing them to move towards more efficient and more formal status in the long run, through a combination of incentives and services. Small informal enterprises should not be the focus of efforts to promote growth, however, as their potential is limited.

Nevertheless, it seems impossible for an economy to develop, when the bulk of economic activity operates outside of the regulatory and tax regime, so formalization of the informal sector must be a long-term objective. For large informal firms with a genuine choice, policy should be oriented toward a more systematically enforced and enforceable regulatory regime.

Few measures have been empirically observed to either increase firm registration or desire to register, or the desire to increase the use of bank loans. It seems that simply promoting registration of firms generates neither the greater productivity nor the financial inclusion of naturally occurring registered firms, without first cultivating the development conditions that cause firms to want to register. Indeed, little formalization will occur and few benefits will accrue from formalization without these developmental improvements, especially in Africa.

Businesses and government should collaborate on an effort to improve both the business environment and tax compliance, in recognition that each side can take actions that will improve the circumstances of the other. Government should improve public-expenditure management and the systematic enforcement of regulations. And firms can gain in productivity and access to bank credit if they modernize and increase formalization. This mutual interest in reforms should be exploited, and such collaboration is more likely to succeed than a unilateral push for new tax revenues from the informal sector.

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