

### BOX 2.6.1 Informality in Sub-Saharan Africa

*Sub-Saharan Africa has high levels of informality, especially in West and East Africa, low-income countries, fragile states, and commodity exporters. Policies to increase human capital and foster productivity, improve access to resources, reduce regulatory burdens, and strengthen governance have been associated with a decline in informality, which in turn has been associated with better macroeconomic and social outcomes. However, for these policies to be effective, they need to be tailored to the specific nature of informality and types of informal firms.*

#### Introduction

Despite a decline over the past three decades, employment informality in Sub-Saharan Africa (SSA) remains among the highest in emerging market and developing economies (EMDEs), with nine out of ten workers informally employed (of which six are self-employed). Output informality (around 40 percent of official GDP) and perceptions of informality are also high compared to other regions. Yet, there is considerable heterogeneity within the region—informality is higher in West and East Africa, low-income countries, fragile states, and commodity exporters. Pervasive informality contributes to lower government tax revenues, which limits the fiscal resources available for much-needed public investment and social programs.

Against this backdrop, this box examines the following questions:

- How has informality evolved?
- What are the macroeconomic and social correlates of informality?
- What are the policy options to address challenges associated with informality?

#### Evolution of informality

**High average informality.** On average in 2010-16, the informal economy in SSA countries amounted to 36-40 percent of official GDP, informal employment made up 90 percent of employment and, more narrowly, self-employment accounted for 58 percent of total employment (ILO 2018a; Figure 2.6.1.1).<sup>1</sup> Alternative measures of informality, such as the share of the labor force without pension coverage and perceptions of informal activity, were also high compared with other EMDE regions.

**Heterogeneity.** There is wide cross-country heterogeneity. West and East Africa had much higher average shares of

self-employed workers in total employment during 2010-16, at 80 percent and 68 percent, respectively. In contrast, the shares of self-employed workers in Central and Southern Africa were 48 and 43 percent respectively, only slightly above the EMDE average. Self-employment made up more than 85 percent of employment in Benin, Burundi, Madagascar, and Uganda whereas it was less than 20 percent in South Africa and Mauritius.

**Evolution of informality in SSA.** Informality in SSA has declined gradually over the past three decades, broadly in line with the EMDE trend. Some countries, however, have made significant progress in lowering the shares of informal output and employment, such as Botswana, Ethiopia, Ghana, Malawi, Rwanda, and Tanzania.

#### Correlates of informality

High informality in SSA reflects wide-ranging economic and development challenges in the region. It also reflects economic structures and a dearth of skilled labor.

**Weak growth and conflict.** SSA hosts all but seven of the world's 34 low-income countries and nearly half of the world's 36 fragile states (World Bank 2018z, 2018aa). In general, informality is higher in low-income SSA countries and, especially, fragile states. Economic disruptions during conflict and violence have forced people to earn their livelihoods in the informal economy (Heintz and Valodia 2008). Employment losses during recessions or shocks to crop production have also been associated with increases in informal labor supply (Calvés and Schoumaker 2004; Daniels 2003; Otsuka and Yamano 2006).

**Economic structure.** In commodity-exporting countries, the capital-intensive mining sector creates few formal employment opportunities, and economies in most countries in SSA have large agricultural sectors that have high rates of informal self-employment. In the non-agricultural sector, there is also considerable self-employment in labor-intensive services such as street vendors, craftsmen, and home-based activities (Fox and Sohnesen 2012). Rural-urban migration and increased labor force participation, especially among women, was mostly absorbed by the informal sector (Kessides 2005). In some societies, informal businesses are hereditary in

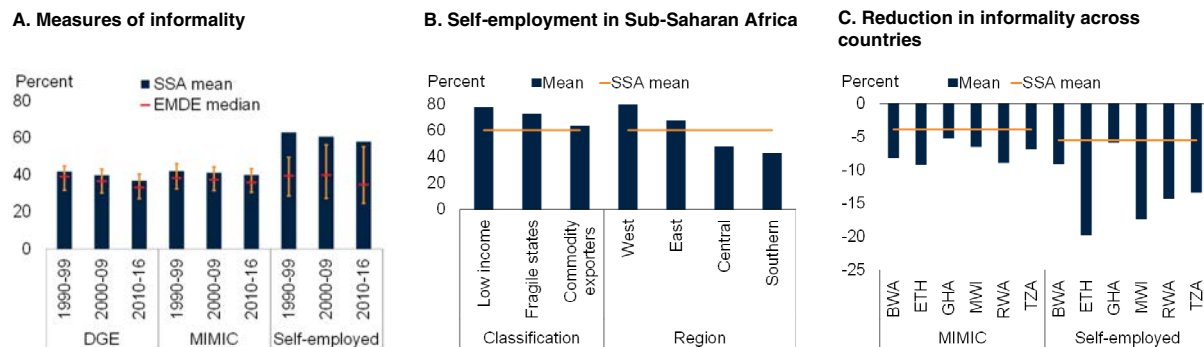
Note: This box was prepared by Wee Chian Koh with research assistance from Jinxin Wu.

<sup>1</sup>A recent enterprise census in Senegal finds that 97 percent of firms are informal (ANSD 2017).

### BOX 2.6.1 Informality in Sub-Saharan Africa (continued)

#### FIGURE 2.6.1.1 Informality in Sub-Saharan Africa

Informality has declined in Sub-Saharan Africa, but remains among the highest in the world. Informality is higher in West and East Africa, low-income countries, fragile states, and commodity exporters.



Source: Elgin et al. (forthcoming), International Labor Organization, World Development Indicators.

Note: A. Orange lines are the inter-quartile ranges for EMDEs.

A. DGE = dynamic general equilibrium model. MIMIC = multiple indicators multiple causes model. The DGE model estimates the size of the informal sector as a percent of official GDP (see Elgin and Oztunali 2012). The MIMIC model is a structural equations model that considers multiple causes of informal activity and captures multiple outcome indicators of informal activity (see Schneider, Buehn, and Montenegro 2010). It also estimates the informal output as a percent of official GDP. Self-employed is the share of self-employment in total employment.

B. World Bank classifications. Data for the period 1990-2016.

C. BWA = Botswana, ETH = Ethiopia, GHA = Ghana, MWI = Malawi, RWA = Rwanda, TZA = Tanzania. Percent change between 1990-2009 and 2010-16.

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nature, where businesses are passed down to the next generation (Chen 2012). In others, social norms restrict the mobility of women, compelling them to be informally employed (ILO 2009).

**Low human capital.** The average years of schooling in SSA are well below those in any other EMDE regions (Figure 2.6.1.2). Informal workers in SSA tend to be lower skilled and less educated than formal workers (Adams, de Silva, and Razmara 2013). This limits opportunities for wage employment in the formal economy. Self-employed workers with low human capital, and hence low productivity, have an incentive to operate in the informal economy to avoid paying taxes and incurring other administrative costs (Oviedo, Thomas, and Karakurum-Özdemir 2009). Informal firms often have lower managerial ability and tend to produce low-quality inexpensive products with little demand from the formal sector (La Porta and Shleifer 2016). The HIV/AIDS pandemic has also taken a large toll on human capital and forced workers into less secure informal employment where discrimination is sometimes less pronounced (ILO 2009).

**Limited access to resources and markets.** Informality is associated with restricted access to electricity, finance, and

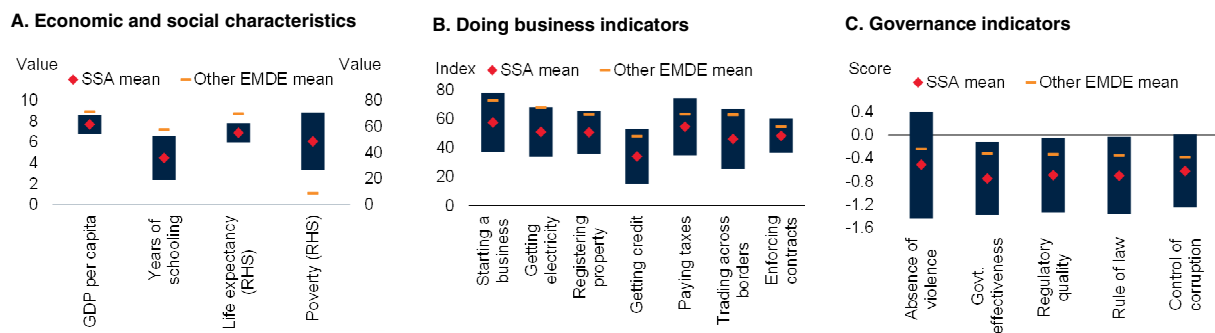
land (Ingram, Ramachandran, and Desai 2007). Limited availability of resources curtails informal firms' growth and productivity improvements (Steel and Snodgrass 2008). There are also obstacles to market access, such as lack of telecommunications or transport infrastructure, which is particularly important for firms that need to frequently interact with suppliers and customers. Access to public space and urban amenities are also important (Heintz and Valodia 2008).

**High regulatory burden.** Compared with other EMDEs, SSA has considerably higher regulatory burdens. Burdensome regulations such as lengthy processes in registering a business, complicated procedures in filing taxes, high costs of export and import documentary compliance, strict labor regulations, and high tax burdens can make it prohibitively expensive to operate in the formal economy (Mbaye and Benjamin 2015).

**Weak governance.** Compared with other EMDEs, SSA has considerably weaker governance and institutions. Poor governance and institutions may result in failures in enforcing regulations and containing corruption. This creates an environment for informal enterprises to easily conceal their activities and evade taxes (Mbaye and Benjamin 2015).

**BOX 2.6.1 Informality in Sub-Saharan Africa (continued)****FIGURE 2.6.1.2 Economic and institutional indicators in Sub-Saharan Africa**

*Low human capital, limited access to resources, heavy regulatory burden, and weak governance are potentially important drivers of informality.*



Source: Barro and Lee (2013), World Bank (Doing Business, World Development Indicators, Worldwide Governance Indicators).

Note: A.-C. Blue bars are +/- one standard deviation of SSA mean. Other EMDE refers to all EMDEs except SSA countries.

A. GDP per capita is based on 2011 PPP in thousand dollars, expressed in logarithm. Life expectancy at birth is in years. Poverty is the headcount at \$1.90 a day (2011 PPP) in percent of population.

B. The index represents the distance to the frontier (100) in the World Bank's Doing Business database. A higher index represents better performance. Data for the period 2004-16.

C. The score is based on Worldwide Governance Indicators. It ranges from -2.5 to 2.5. A higher score represents better performance. Data for the period 1996-2016.

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**Low productivity.** Productivity differentials between the formal and informal sectors are large: value added per worker of informal firms is only 14 percent that of formal firms in the median SSA country, lower than the median in other EMDEs (La Porta and Shleifer 2014). Competition from informal firms, which do not shoulder the cost of compliances with taxes and regulations, also weigh on the profitability and investment of formal firms (Oosthuizen et al. 2016; Box 3.3). Although practices of competitors in the informal sector is only the third biggest reported obstacle in SSA, after electricity and access to finance, it is more problematic in SSA compared to other EMDEs (Dinh, Mavridis, and Nguyen 2010; La Porta and Shleifer 2016). In addition, since informal firms do not pay taxes, governments' ability to provide quality public services is constrained.

**Poverty and social outcomes.** While the informal economy can provide important opportunities for employment, the majority of those engaged in informal activities lack income security, employment benefits, and social protection. Moreover, higher informality in SSA is associated with lower life expectancy and worse poverty outcomes (Figure 2.6.1.3). Gender inequality is also prevalent in the informal economy in SSA: women are often placed in the most hazardous jobs with no access to occupational health and safety measures (ILO 2009).

## Policy challenges

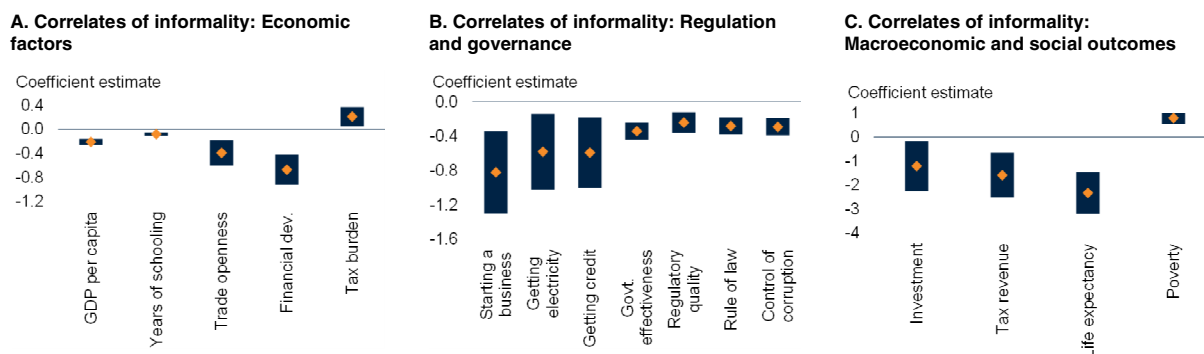
**Unlocking the potential of the informal economy.** While informality is more pervasive in SSA than in other EMDE regions, the move from informality to formality is more dynamic: more SSA formal firms started out as informal and the duration of informality is shorter than in other EMDEs (Figure 2.6.1.4). SSA also possesses a more positive attitude toward business opportunities than other EMDE regions, despite a higher proportion of people who became entrepreneurs out of necessity. Two-thirds (65 percent) of survey respondents believe they have the required skills and knowledge to start a business, 59 percent indicate they see good opportunities to start a firm, and 42 percent intend to start a business within three years. This intrinsic entrepreneurial spirit, despite high regulatory burdens and a weak entrepreneurship ecosystem, could render the informal sector a reservoir of untapped economic potential (De Soto 1989; Grimm, Knorringa, and Lay 2012).

To unlock this potential, both broad-based policy tools—such as increasing human capital—and policy tools targeted at specific parts of the informal sector are available. In Kenya, for example, improved managerial skills and new marketing channels induced by competition helped metalwork enterprises in the Kariobangi Light

### BOX 2.6.1 Informality in Sub-Saharan Africa (continued)

#### FIGURE 2.6.1.3 Correlates of informality in Sub-Saharan Africa

Improvements in economic and institutional factors are associated with a reduction in informality. High informality is associated with worse macroeconomic and social outcomes. Years of schooling and primary school learning assessment scores in Sub-Saharan Africa are among the lowest in the world. Investing in human capital is critical to improve labor skills.



Source: Barro and Lee (2013), Elgin et al. (forthcoming), World Bank (Doing Business, World Development Indicators, Worldwide Governance Indicators).

Note: The orange diamonds are the coefficient estimates and the blue bars denote the 90 percent confidence intervals. OLS estimators are applied, with country means over the sample period used for both the dependent and independent variables. The share of self-employed in total employment is the measure of informality. Informality is the dependent variable in A.-B., and it is the independent variable in C. 37 SSA countries are included in the regressions. The coefficient estimate measures the effect on the dependent variable of a unit change in the independent variable. For example, in A., a 1 percent increase in the tax rate is associated with a 0.2 percent increase in informality. In C., a 1 percent increase in informality is associated with a 1.6 percent decline in government tax revenue.

A. GDP per capita is based on 2011 PPP in thousand dollars, expressed in logarithm. Trade openness is total trade (exports + imports) as a share of GDP. Financial development is proxied by private credit as a percentage of GDP. Tax burden is the total tax rate using data from Doing Business. Data for the period 1990-2016.

B. The correlates are the distance to the frontier in Doing Business (data for the period 2004-16) and the scores based on Worldwide Governance Indicators (data for the period 1996-2016).

C. Investment is gross fixed capital formation as a percentage of GDP. Tax revenue is expressed as a share of GDP. Life expectancy at birth is in years. Poverty is the headcount at \$1.90 a day (2011 PPP) in percent of population.

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Industries grow and transition to the formal economy (Sonobe, Akoten, and Otsuka 2011). The local government provided little support other than designating an area for these artisans to operate, but that proved to be sufficient.<sup>2</sup>

**Investing in human capital.** Policies should be prioritized toward increasing human capital. Less than 20 percent of primary school students in Sub-Saharan Africa—typically from poor households—pass a minimum proficiency threshold in learning assessment, which is the lowest among EMDEs (World Bank 2018n). Teachers are also often absent from classrooms. These learning deficiencies amplify over time and eventually show up as weak labor skills. Although technically and politically difficult, serious efforts must be made to improve learning outcomes.

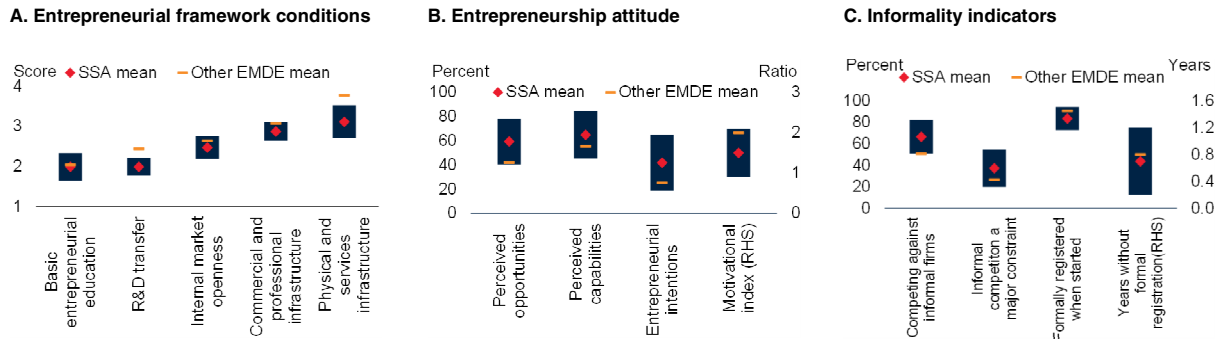
<sup>2</sup> Also in Kenya, the M-Pesa mobile money transfer system, combined with affordable ICT services, increased microenterprises' profitability (Mbogo 2010). Improving the survival chances of these microenterprises is one pathway toward growing the formal economy. David et al. (2012) provide other examples of successes at the local government level.

**Increasing firm productivity.** Small informal firms, lacking in human capital, would not sharply increase their productivity by merely registering (La Porta and Shleifer 2016). In contrast, large informal firms resemble formal firms much more than their small informal counterparts: productivity differentials of large informal firms relative to formal firms are minor (Benjamin and Mbaye 2012). In West Africa, the largest and fastest growing sectors are, in fact, dominated by large informal firms. This argues for policies to encourage small firms to grow into more productive formal firms, through skills upgrading and better access to inputs and resources such as business development services, transport and communications connectivity, financial services, health services, land and property rights, infrastructure, technology, and product markets (Oosthuizen et al. 2016). As these firms become more productive and produce higher quality products, they may be able to participate in supply chains in the formal sector (La Porta and Shleifer 2016). For large firms or those that voluntarily remain informal to evade taxes or avoid labor codes, incentives to encourage formal

**BOX 2.6.1 Informality in Sub-Saharan Africa (continued)**

**FIGURE 2.6.1.4 Entrepreneurial conditions, entrepreneurship attitude, and informality indicators in Sub-Saharan Africa**

Despite a higher proportion of necessity-driven informal entrepreneurs, Sub-Saharan Africa benefits from more dynamic entrepreneurial attitudes. More formal firms in Sub-Saharan Africa than in other EMDE regions started out as informal firms. However, small informal firms often lack managerial skills and resources. Skills upgrading and improving access to resources can help informal firms become more productive and therefore compete in the formal sector.



Source: Global Entrepreneurship Monitor, World Bank Enterprise Surveys.  
 Note: Blue bars are +/- one standard deviation of SSA mean. Other EMDE refers to all EMDEs except SSA countries.  
 A. The score is based on National Expert Survey of the Global Entrepreneurship Monitor. It ranges from 1 to 9. A higher score represents better perceived condition.  
 B. Data from the Adult Population Survey of the Global Entrepreneurship Monitor for the period 2001-16. Motivation index is the percentage of those who have recently started a business that are improvement-driven opportunity motivated divided by the percentage that is necessity-motivated. A lower ratio indicates a higher proportion that is necessity-driven.  
 C. Data from the World Bank Enterprise Surveys for the period 2006-16.  
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registration can be combined with tighter enforcement (Mbaye and Benjamin 2015).

**Building institutions.** Regulatory and institutional reforms to build public trust can strengthen incentives for firms to operate formally (Mbaye and Benjamin 2015). This includes improving the business environment by removing unnecessary regulatory barriers, strengthening monitoring and enforcement capabilities, and upholding legal and judicial systems. These policies apply equally to formal firms as an enabling environment is critical for investment and employment generation. Improving macroeconomic stability with sound fiscal and monetary policy frameworks is also essential.

**Stakeholder engagement.** Governments can actively engage with the informal community to encourage a shift towards greater formality (ILO 2009). This can involve educating informal firms on the benefits of formal registration, providing information on the procedures, participating in social dialogues to understand pressing issues for informal firms, customizing household surveys to better capture important aspects of informality, and collaborating with informal actors to design and implement effective development policies.