The Informal Economy, Economic Growth and Poverty in Sub-Saharan Africa

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1. Introduction

Prior to the 1970s when the International Labour Organisation sponsored several surveys of labour markets in developing nations, issues of informality and the informal economy were regarded simply as a failure of the market that could be corrected with policy. Since then the debate on the informal economy and its position and role in developing economies has gained considerable new attention and interest, especially in Sub-Saharan African economies, where there is evidence that a majority of the population depends on the informal economy for their livelihoods, and that this structure is also drawn from socio-cultural norms influenced by many years of social engagement. By current estimates it is not unusual for the informal economy to account for over half of Gross Domestic Product and employment in developing countries, including in Sub-Saharan Africa (SSA) (Charmes, 1999).

Despite the growing interest, there remain different and ambivalent attitudes towards the informal economy which is sometimes seen as a major problem that has to be solved. In some circles it is seen as made up of people engaged in activities that may be viewed as clandestine and illegal. However, it is also seen by many as a spontaneous and creative response to the formal economy's incapacity to satisfy basic needs. For many economists, the informal economy has often been viewed as a temporary alternative to unemployment and a coping mechanism against poverty which would disappear as an economy matures and becomes more developed. It is therefore not surprising, that many economists initially associated informal economic activity with developing countries where decent work deficits were most pronounced and social safety nets were relatively underdeveloped.

The history of developing economies suggests, however, that the informal economy may not necessarily be a passing phenomenon. Its presence in Africa could be associated with not only the structure of the economies but has also evolved from a number of traditional practices. About 7 out of 10 new jobs may be found in the informal economy. The sheer size of the informal economy, estimated at about 42 percent of GDP in SSA in 2000, is forcing governments to acknowledge its

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significance and importance to the national economy and the welfare of those employed (Devey, Skinner and Valodia, 2006). Even in South Africa with a much larger formal economy, the informal economy still contributes between 7 and 12 percent of GDP (Devey, Skinner and Valodia, 2006). The informal economy also plays a key intermediate role of linking sub-sectors of the formal economy to consumers; it supplies the low and middle income employees of the formal economy with products and services not offered by the formal economy.

An illustration of the ambivalence towards the informal economy is the oft-repeated general assertion that "the informal economy is here to stay", no doubt defying all attempts of "formalization". The policy question for many governments and analysts that flows from this is whether to give up attempts they usually make to "formalize" the informal economy and lose such potential gains as an exponential increase in the tax base of economies or not. There are also questions about the overall importance of the informal economy to future growth in African economies and how growth affects the dynamics of the informal economy. Similarly there are questions about whether the informal economy is the way out of poverty and what will happen to it with changes in the incidence of poverty. Or is it the case that the continuing informality of many economic transactions takes away the incentive to grow the activities that will take individuals and households out of poverty. It is obvious that there are still several dimensions of the role that informality plays in African economies, and that these have to be better understood in order to make clear the links between growth and poverty. The informal economy obviously presents one set of institutions and relationships that have a significant bearing on what happens to growth and poverty in most African countries.

This paper seeks to document the current state of affairs with respect to understanding how informality affects economic growth and poverty in SSA countries. It identifies various studies that have sought to show the relationship between economic growth and informality as well as between poverty and informality. The discussions also present the types of methodologies and data used for the analyses. Some of the policy discussions that have taken place recently are also presented in this paper.

The paper has eight sections; with the introduction followed by section 2 which gives a brief discussion of some of the conceptual issues on the informal economy evolving over the years. Section 3 looks at informal institutions in the light of institutional economics, providing a theoretical framework for understanding informality. Section 4 provides a detailed overview of the role of the informal economy in the growth process, drawing out some of the barriers hindering its development. Section 5 covers the informal economy and poverty. In section 6 the broad literature on formalizing the informal economy is reviewed, followed by a discussion of strategic options which can be taken to engage the informal economy in productive activities in section 7. Section 8 is the concluding section.

2. Defining the Informal Economy – Some Conceptual Issues

Generally, the informal economy refers to the part of the economy that does not fall under the purview of organized economic activities. Early discussions of the "informal sector" came with the work of Dudley Seers and his engagement with the World Employment Programme initiated by the International Labour Organization. The term itself is more usually associated with the work of Keith Hart who tried to give a definition to the phenomenon of the mass unemployment in poor countries arising primarily from urban migration without any meaningful expansion in the industrial base (Hart, 1973). There have been several arguments surrounding his initial classification of the activities of the unemployed as constituting the "informal sector". However, his main insights were into the complexity of how livelihoods are shaped, the intertwining of different types of activities, and the role of the state and bureaucracy in both developed and developing economies (Hart, 2006). Early studies of the "informal sector" were sometimes criticized for being confused, in that they did not clearly define what the "informal sector" was. Conceptually, the informal economy focuses on activities that have less form and structure; that operate away from bureaucratic controls, and which are likely to be more precarious and not so stable. In his early work, Hart did not necessarily see informal activity as a 'sector' but rather the plethora of ways that people engage in, sometimes simultaneously formally and informally (Hart, 2006). "The concept of 'informality' says nothing about the positive dynamics of these activities or about the social forms that organize them, lumping together street hawkers, criminal gangs, construction workers and tax evasion, as well as a grey zone where emergent urban commerce engages with the forces of the world economy. I now think of the informal economy as *the rise of the market* in the new African cities. While the term points to the ambiguous relationship of this commerce to state regulation, it does not help us to understand how the activities it groups together might be a platform for more sustained economic growth in future" (Hart 2008).

The ILO first introduced a statistical definition for the informal economy in a January 1993 Resolution adopted by the 15th Conference of International Labour Statisticians (ILO 2002a). Following from this, the 17th ICLS defined informal employment as a broader concept, which includes the "informal sector" as well as informal employees working for formal economic units without being registered or declared by their employers (ILO, 2003). This came about as interest in the size of the informal economy and its contribution to national income and economic welfare increased and also an increase in the demand for a more scientific measurement of this economy's size. Indeed, growing global competition and its threatening effect on employment in the formal economy requires a conceptual framework that encompasses all the various aspects of the informal economy.

This conceptualization has been further developed in the past couple of years, as evidenced by the number of new studies (Chen 2004; Guha-Khasnobis et al, 2006, Henley et al, 2006). In this paper, informal activity will be generally seen as small-scale low income activities, whether in employment or self-employment, whether linked to registered firms or not. Informal employment may include unpaid family workers, workers with precarious employment conditions in formal enterprises and certain employment in households producing goods exclusively for their own use or employing paid domestic workers. Formal and informal assets are not comparable. The key distinction is that informal assets seldom carry proper titles; they cannot be used as collateral for formal loans which implies that many profitable opportunities to build wealth are left untapped in the informal economy (De Soto, 2000). Table 1 below offers a description of some of the informal economy typologies in comparison with the formal economy.

Table1: Informal Economy Typologies

Attributes	**Informal Economy**		**Formal Economy**
	Subsistence Enterprise	Unofficial Enterprises	Official Enterprises
Degree of informality	Very High	High. Proportion of sales undeclared and workers unregistered	Some proportion of sales undeclared and some workers unregistered. May use outside official

			purview (e.g. internet to deliver software)
Type of activity	Single street traders, cottage/micro enterprises, subsistence farmers)	Small manufactures, service providers, software firms	Small and medium manufactures, service providers, software firms
Technology	Labour intensive	Mostly labour intensive	Knowledge and capital intensive
Owner profile	Poor, low education, low level of skills	Poor and non-poor, well educated, high level of skills	Non-poor, highly educated, sophisticated level of skills
Markets	Low barriers of entry, highly competitive, high product homogeneity	Low barriers of entry, highly competitive, some product differentiation	Significant barriers to entry, established market/product niche
Finance needs	Working capital	Working capital, some investment capital, supplier credit	Investment capital and working capital, letters of credit, supplier credit
Other needs	Personal Insurance, social protection	Personal and perhaps business protection	Personal and business protection, business development services
	Least Dynamic Completely Informal		Highly Dynamic Partially Formal

Source: Adapted from Djankov et al. 2002

Measuring the Size of the Informal Economy

Measuring the size of the informal economy, in terms of production and employment, is difficult because of its nature and composition. It is generally conceded that surveys are difficult to use to measure the size of the informal economy. Despite this, they have become the main tool for determining the size of the informal economy. The informal economy comprises mainly households with at least some market production and production units with low levels of organization and technology. There is often unclear distinction between labour and capital or between household and production operations. Also, these units are characterized by high mobility and turnover, seasonality, lack of recognizable features for identification, and reluctance to share information. Furthermore, informal units are usually not covered by establishment or enterprise surveys, and hence often not included in the sampling frames for many industrial surveys. They might, however, be covered by household surveys, which usually do not include questions pertaining to production.

Informal economy statistics are not collected through the regular survey system of national statistical offices (NSOs), thus leading to distorted estimates of the structure of economies (ADB, 2007). The lack of information also hinders the understanding of policy makers about many socioeconomic issues related to informal economy activities, such as lack of social protection, limited access to credit, training, and markets; and differentials in wages and working conditions. Ultimately, policies and interventions that are formulated and implemented to reduce poverty by generating more jobs might not result in the desired outcome.

Generally, there are three accepted methods for estimating the size of the informal economy: (1) direct approaches that employ household surveys or audit tax returns to extrapolate data relating to informal activities; (2) indirect or discrepancy methods that use available economic data to estimate changes in the size of the 'shadow' economy over time; and (3) modelling approaches, which examine the causes and effects of informal activities to estimate the size of the informal economy. The collection of data on the informal economy can take many approaches—independent surveys, mixed household–enterprise surveys, labour force or other household surveys, or the expansion of coverage of establishment surveys and economic censuses.

Developing countries with limited public funds cannot sustain many of these approaches, because conducting regular national surveys requires sizeable budgets (ADB, 2007). Sadly, many of these same countries have large informal economies and informal employment that need to be measured. The available statistics for those few countries that have incorporated questions pertaining to the informal economy into their labour force surveys might not be comparable with other countries because of differences in definition and concepts. Although the definition of the informal economy was established at the 15th International Conference of Labour Statisticians, while the definition of informal employment was established at the 17th conference, many countries have not applied these definitions uniformly.

Currently, the International Labour Organization database reveals differences in countries' practices, data collection coverage, operational definitions, and data collection methods. The International Conference of Labour Statisticians and the United Nations Expert Group on Informal Sector Statistics (or Delhi Group), which was constituted in 1997 has been mandated to harmonize national definitions of the informal economy to improve international comparability.

Recent studies seeking to measure the size of the informal economy include that of Loayza and Rigolini (2006) who used self-employment as a proxy measurement of informality. Their study was based on data from 18 developing and 24 developed or high-income economies using national labour force surveys compiled by the ILO as well as some time series data[2]. The observations in the study are given at the national level, so that the variation in the data (and, thus, its informational value) resides on their cross-country and time-series dimensions. In studying what they saw as the trends and cycles of informal employment, Loayza and Rigolini (2006) first present a theoretical model where the size of informal employment is determined by the relative costs and benefits of informality and the distribution of workers' skills. In the long run, informal employment varies with the trends in these variables, and in the short run it reacts to accommodate transient shocks and to close the gap that separates it from its trend level. The authors use an error-correction framework to examine empirically informality's long- and short-run relationships.

Loayza and Rigolini (2006) find that, in the long run, informality is larger in countries that have lower GDP per capita and impose more costs to formal firms in the form of more rigid business regulations, less valuable police and judicial services, and weaker monitoring of informality. Informal employment is determined by the trends in the relative costs and benefits of informality in

[2] The country-level data at annual frequency measured the share of self-employment in the labour force The data consist of annual observations for a collection of developing and developed countries over diverse time periods.

the long run. In the short run, informal employment is found to be counter-cyclical for the majority of countries because informal employment reacts to the temporary conditions created by the business cycle. However, the degree of counter-cyclicality was found to be lower in countries with larger informal employment and better police and judicial services. Overall, the study showed that informal employment follows a stable, trend-reverting process.

Galli and Kucera (2003) carried out a study of informal employment in 14 Latin American countries where they defined informality with employment in small firms with less than ten employees as well as self-employment and domestic work. Their paper addressed three central issues in the debates on informal employment, namely, trends in informalisation, informal employment as a macroeconomic buffer over business cycles, and the effects of higher labour standards and stronger *de facto* worker rights on informal employment. In particular, the authors test the hypothesis that stronger "civic rights" – such as freedom of association and collective bargaining rights – and higher wage shares in the formal economy reduce employment and thereby contribute to informalisation. The issues are explored using panel data on specific categories of formal and informal employment for fourteen Latin American countries in a period of only eight years, from 1990 to 1997, and evaluating both cross-country and time series variation. In the context of an increasing share of informal employment in the 1990s, they suggest that informal employment acted as a cyclical buffer for formal employment. Regarding labour standards, Galli and Kucera (2003) suggest that countries with stronger "civic rights" may have higher shares of formal employment and lower shares of informal employment, even after accounting for per capita income and other control variables.

Galli and Kucera (2003) pursue the issue of cyclical patterns of formal and informal employment with the buffer hypothesis, based on estimated GDP elasticities for each employment category. The buffer hypothesis suggests that informal employment serves as a macroeconomic buffer for formal sector employment over the course of business cycles, with informal employment expanding during downturns and contracting during upturns. Although there is little systematic evidence on the cyclical movement of informal employment some available studies may suggest the expectation of a countercyclical pattern as seen earlier in Loayza and Rigolini (2006).

Galli and Kucera (2003) have also suggested that heterogeneity of informal employment makes it difficult to have an *a priori* expectation about the cyclical behaviour of informal employment. It is expected that the different categories of informal employment will demonstrate varying degrees of cyclical behaviour. For instance, in considering the “survival”, “independent” and “subordinate” types of informal activities proposed by Portes (1994b); it is likely that survival activities will have a countercyclical pattern, while autonomous informal employment is likely to have pro-cyclical pattern as it is closest to the idea of voluntary self-employment. Informal activities subordinate to the formal economy could be either counter-cyclical, if firms make more use of sub-contracting and outsourcing during recessions, or pro-cyclical, if subordinate informal activities are reduced together with production in the formal economy. As a result, estimates of the cyclical movements of informal employment as a whole may derive from the relative importance as well as the sign and the magnitude of the output elasticities of employment of different kinds of informal employment.

Galli and Kucera (2003) note that, consistent with the buffer hypothesis, elasticities are significantly negative for both small firms and self-employment while remaining significantly positive for large firms. Evidence from their study largely supports the buffer hypothesis, indicating a strongly robust pro-cyclical behaviour of private formal employment shares, and a quite robust counter-cyclical behaviour of employment shares in small firms and self-employment. However, the data is based on employment shares, not absolute numbers of employment.

In the study by Galli and Kucera (2003) the evidence on the relationships between labour standards and formal and informal employment may be summarized as follows. On trend regressions, there is the observation that countries with stronger civil liberties and higher wage shares tend to have higher shares of employment in large firms and lower shares of employment in small firms and self-employment. This is used to suggest that countries with stronger “civic rights” and higher manufacturing wage shares, (which is their proxy for formal sector wage shares) tend to have higher shares of formal employment and lower shares of informal employment. The trend regression results evaluating “civic rights” are more strongly robust than results evaluating wage shares with respect to adding additional control variables and dropping one country at a time from the sample.

In sum, they find robust evidence that countries with stronger “civic rights” have higher shares of formal employment and lower shares of informal employment, even accounting for GDP per capita and other control variables, and no conclusive evidence on the nature of these relationships within countries over time. The process through which countries reach their long-run position therefore remains unclear.

3. Informality and Institutions in Economic Development

It is possible to analyze the development of informal arrangements in the production of goods and services within the context of institutional economics. This is generally seen to be largely a consequence of the failure of neoclassical economic theory to explain resource allocation and decision making within the informal context. If one argues that the development of informal arrangements is the consequence of a gap between policies that are intended to achieve specific development objectives and outcomes, and the actual institutional environment in which they occur, institutional economics offers an alternative framework for analyzing its occurrence and evolution. Indeed it may be argued that the gap between policy and environment for implementing development policies is wider in Africa than elsewhere, and hence the emergence of economic arrangements that allow agents to achieve their smaller objectives (Nissanke and Aryeetey 2003).

The two schools of institutionalism in economics take off from conventional neoclassical equilibrium analysis by arguing that inefficient resource allocation and the low-growth path of any economy are linked "to their inability to transform institutional structures in response to new technological and market opportunities" (Nissanke and Aryeetey 2003). In this situation institutions become either fundamental facilitators of development or significant obstructions. They could be significant in reducing uncertainty and reducing transaction costs. They are also crucial for promoting the acquisition of knowledge and technology. In this context institutional economics is generally perceived to offer a framework of what institutional changes are essential for economic development. It also makes possible the development of tools that will inform institutional design and policy alternatives.

Discussions of the old and new institutional economics are found in studies by Harriss et al. (1995) and Stein (1995). While the old institutional economics does not accept the idea of rational-maximizing atomistic agents embedded in neoclassical thinking, it is seen as taking organizations and entities which operate in a "complex historically specific environment of social, economic and legal institutions, as a unit of analysis" (Nissanke and Aryeetey 2003). In this situation economic systems are the outcomes of constant adjustments to existing institutions and these adjustments are motivated by technical change (Harriss et al., 1995).

While adopting the neoclassical choice-theoretic approach, the new institutional economics adds to it the role of transaction costs in exchanges. Indeed it explains how institutions support the formation and operation of markets, minimizing transaction costs and reducing uncertainty. In this conceptualization, institutions evolve and are improved with time in order to deal with market failures, imperfect and costly information, as well as the agency and incentive problems. Within this context informal arrangements can be seen as allowing individual economic agents to overcome specific social and other operational challenges.

In the new institutional economics, the fundamental unit of analysis is the transaction or exchange that takes place between economic agents. Transactions can be organized or coordinated by markets, organizations or by what have been referred to as hybrid forms, including cooperatives and clubs. In providing economics with both "theory" and "institutions", the new institutional economics looks at the types and levels of institutions, including the institutional environment or the rules of the game. That is what leads to the development of informal and formal rules. It is important to note that the rules mainly define the environment of a governance structure or arrangements for implementing and operationalizing policies, etc, and the environment may also include social capital.

Formal rules include laws and rules of society. They are enforced in particular ascribed ways and they are monitored regularly. There are usually sanctions for non-compliance and conflict-resolution mechanisms are often applied. Informal rules on the other hand consist of sanctions, taboos, customs, traditions, norms, values and beliefs and common codes of behaviour. Social capital is shared knowledge, understandings, norms, rules, and expectations about patterns of interactions that groups of individuals bring to a recurrent activity. Trust is considered to be the most important component of social capital. It is often argued that small amounts of social capital in society will lead to higher transactions costs. All of these together provide an environment that allows economic agents to engage in exchanges with a view to minimizing the costs that they otherwise would face. Based on these conceptions of the environment, Williamson (1985) provides four levels of institutions and these allow us to place informality within the framework of institutional analysis.

Figure 1: The Levels of Institutions

Level 1	**Frequency (years)**	**Core elements**	**Purpose**
Level 1 Social theory	100 to 1000	Embeddedness: informal institutions, customs traditions, norms, religion	Often non-calculative; spontaneous
Level 2 Economics of property	10 to 100	Institutional environment: formal rules of the game - especially property (polity, judiciary, bureaucracy)	Get the institutional environment right; 1st order economising
Level 3 Transaction Costs Economics	1 to 10	Governance: play of the game - especially contract (aligning governance with transactions)	Get the governance structures right; 2nd order economising
Level 4 Neo-classical Economics / Agency theory	continuous	Resource allocation and employment (prices and quantities; incentive alignment)	Get the marginal conditions right; 3rd order economising

But there is no need to consider the different levels of institutions as cut off fro one another. Zenger et.al. (2002) have looked at formal and informal organizations in economic exchanges. They stress the roles of formal institutions (contracts, incentives, authority) and informal institutions (norms, routines, political processes) and suggest that these are deeply intertwined. They note that "informal institutions are usually treated as exogenous forces which change the benefits to using alternative formal structures, and formal institutions are treated as mere functional substitutes for informal elements governing exchanges." In view of this approach they suggest that not much attention has been paid to exploring the interactions between formal and informal institutions. They contend that by not integrating these concepts into a common theory, faulty reasoning and incomplete theories of economic organizations are used in discussing these institutional arrangements in the production of goods and services. Their paper explores three potential areas of research, including the interplay between formal and informal institutions. They first look at whether formal institutions complement or undermine informal institutions. They then consider how "vacillation in formal organizational modes allows managers to efficiently alter the trajectory of informal institutions". Finally, they consider how certain informal institutions can lead to hierarchical failure, thereby requiring managers to constrain the boundaries of the firm.

It is clear from the discussion here that institutional economics offers a framework for appreciating the role of exchanges and transaction costs and how these lead to institutional choices that could impact the growth trajectory of an economy. What is not quite clear yet is how the resulting institutions relate to one another and how that affects the production outcomes. Research that seeks to understand these relationships in an African context should be very useful. It is important to understand the issues of competition and substitution from a country-specific and socio-cultural context. Considering that spatial differentiation matters for the formal-informal dichotomy, will changes in the movement of persons have an effect on how these institutions develop? Bearing in mind that the operations of the informal sector are often subject to arbitrary legal regimes, both at the national or at the community level, how will changes in the political environment affect the evolution of the informal economy?

4. The Informal Economy and Economic Growth

The current global economic crisis is leading to a downward revision of economic growth rates worldwide. Currently SSA is expected to growth at less than 2% in 2009 while other regions grow even slower. As the sizes of economies contract, will the informal economy in these countries contract or grow relative to the formal economy? Throughout the world, millions of workers are being laid-off as inefficient companies are either shut down or downsized. In SSA the effects are expected to be similar to the effects of the Structural Adjustment Programmes of the mid-1980s as firms lose considerable revenue as a result of the reduced demand for their exports (AfDB 2009). SSA economies also expect to see reductions in the flow of private capital, as well as significant reductions in aid flows and remittances. How will all of this affect the informal economy and its contribution to economic growth?

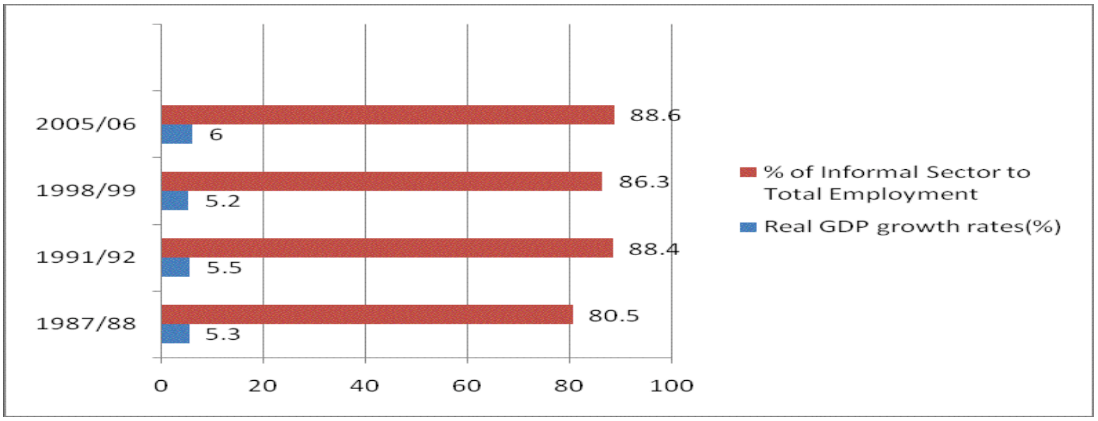
The arguments in section 4 on counter-cyclicality and pro-cyclicality will suggest that at the minimum large parts of the informal economy will see an expansion as unemployment increases in the formal economy. It has been argued by Ranis and Stewart (1999) and by Tokman (2001) that when economic growth rates decline, firms in the formal sector tend to contract by retrenching employees in order to reduce operating costs. It is this expected high levels of unemployment that are expected to invariably lead to an expansion of the informal sector and the informal economy. But it is not by any means clear that the informal economy is able to always offer productive engagements.

Trends in Economic Growth and Informality

The relationship between economic growth and informality has always yielded considerable interest at different points in time. In the early days of development economics, growth was seen as the growth of organized economic activities through rapid industrialization via capital formation and the expansion of domestic and export demand. However, that optimistic vision of economic transition did not match what was actually happening in the world. What the market failed to do was to take into account the ever growing number of people who were caught in activities that fell outside of this zone of the 'formal' sector. Literally, the 'informal sector' was viewed as a temporary situation that would vanish with the take-off in economic growth.

The expansion of the informal economy over several years and the deteriorating employment situation in many developing countries in SSA, Latin America and the Caribbean was believed to be associated with low GDP growth rates (ILO, 2004). As seen from many recent studies, this view about informality and economic growth may not be entirely valid. Latin America experienced economic recovery and growth in the 1990s but it is still faced with an increase in unemployment (Becker, 2004). Until the recent downturn in the global economy, SSA experienced one of the fastest growth rates in its history and also in the world over the last six years, and yet this did not affect negatively the size of the informal economy. There is indeed evidence of an ever expanding informal economy in this region. In Ghana, for real example, real GDP growth has averaged 5.2% in the past two decades, rising to more than 6 percent since 2006 and yet the informal economy share of total employment has increased from 80.5% between 1987/88 to 88.6% between 2005/06 (Figure 2).

Figure 2: Ghana's Real GDP Growth and % Contribution of Informal economy to Total Employment (1987-2006)



Source: Estimates drawn from various budgets and Ghana GLSS data

Since the late 1960s and 1970s, large sections of the population in developing countries have suffered from poverty and are engaged in the informal economy. Economic growth seems to be unable to reduce the size of the informal economy fast enough. This has been mainly attributed to increases in population growth and urban migration; hence the active labour force grows at a much faster rate than the availability of jobs in the organized or formal sector. Many countries in the developing world are experiencing distinctive "youth bulges", which occur when young people comprise at least 4 percent of the population. There has been increasing concern among policymakers that the frustrations accompanying long-term unemployment among large populations of young men in urban areas may feed political and ideological unrest and provoke violence.

Increasingly, the contribution of globalization to high unemployment rates in developing economies is evident. The disintegration of production and the integration of trade, whereby global buyers are outsourcing some of their activities in labour advantageous regions has led to the retrenchment of many low-skilled workers who had originally been involved in the activities being outsourced (Feenstra, 1998). Beyond these explanations, there have been suggestions that in some countries the informal economy is preferred, and is entered voluntarily (Chen 2004). The reason often given is that there are complementarities that exist between the formal and informal economies which make it impossible to completely transform the informal economy to a formal one. Chen (2004) argues that that most informal enterprises and workers are intrinsically linked to formal firms.

There is the notion that the relationship between economic growth and informality is driven to a large extent by how growth impacts the lives of the poor in an economy and what access the poor may have to the growth points in an economy. This makes it necessary to look briefly at the relationship between economic growth and poverty.

Which Kind of Economic Growth?

The conceptual issues regarding economic growth and poverty are wide and varied. However, whether economic growth leads to poverty reduction or not is an issue that has been debated for years among governments and economists. There are those who advocate growth at all cost and those who suggest that the emphasis be placed on policies that directly affect the poor. Yet, the impact of economic growth on the rate of poverty reduction depends on the nature, strength and other characteristics of the links that exist between growth and poverty at a given point in time and in a particular country. Therefore it is a complex issue to direct countries to follow a strategy of growth maximization as its pro-poor growth stance.

In principle, different growth strategies induce different patterns of growth that differ in both the rate of economic growth and the resulting distribution of income. These two interdependent outcomes simultaneously determine the extent to which a particular growth strategy is pro-poor along with its capacity to reduce poverty. One obvious conclusion that follows from the above is that whether maximizing the rate of economic growth is equivalent to maximizing the rate of poverty reduction at a given point in time is very much an empirical issue on which no general conclusions can be drawn. The effectiveness with which economic growth translates into poverty reduction depends on initial conditions (e.g. initial income distribution), the stage of development, and other socio-economic characteristics of a country.

In particular, the degree of inequality determines the strength of the poverty elasticity of growth so that if the strategy of growth maximization leads to a rapid accentuation in income inequality, the poverty-reducing impact of the strategy may be less compared to an alternative strategy. It can have a higher impact on poverty due to generating a growth process which is more equalizing in nature.

Analysis of the relationship between economic growth and poverty reduction has gone through various phases in the literature on development. For example, an important premise of the very early theories of development was that the benefits of economic growth would trickle down to the poor. Since then, questions have been raised about the assumption of an automatic link between growth and poverty reduction, and attempts have been made to understand the mechanisms through which the benefits of growth may get transmitted to the poor. Some of the latter categories of studies do also refer to the role of employment; and yet, a rigorous analysis of the role of employment in the linkage between economic growth and poverty reduction appears to be missing.

Following on the Kuznets (1955) hypothesis of an inverted U shape of the relationship between economic growth and income inequality, Adelman and Morris (1973) had one of the earlier studies to question the automaticity of the relationship between economic growth and benefits to the poor. And then came the influential contribution by Chenery, et al. (1974), focusing on the importance of redistribution alongside economic growth. Economic growth, however, came back into fashion once there were studies casting doubt on the suggestion that higher growth could be associated with increased poverty, and re-asserting that growth, almost always, reduced poverty. The decade of the 1980s witnessed renewed emphasis (especially on the part of the international development partners) on economic growth; but studies on growth contributing to poverty reduction again came in good numbers during recent years.

While growth continued to occupy the centre stage in development literature, there have been studies, especially in recent years, arguing that although growth is necessary for poverty reduction, it is not sufficient. Some studies point out that the pattern of growth is important from the point of view of its effectiveness in reducing poverty (World Bank, 1990; Lipton and Ravallion, 1995; Squire, 1993; McKay, 1997; DFID, 1997). While discussing the pattern of growth that could be more effective in reducing poverty, some studies mention explicitly the importance of labour-intensive growth – World Bank (1990), Squire (1993), McKay (1997), and DFID (1997), ILO (2003) for example. The relevance of all of this discussion lies largely in how inequalities between rural and urban areas are managed.

Pro-Poor Growth

Pro-poor targeted expenditures directly serve the purpose of poverty reduction. In contrast, broad-based (shared) expenditures contribute to GNP growth first and then to poverty reduction by way of increased savings, which are channelled through fiscal resources or banks to particular uses targeted at poverty reduction. Pro-poor growth has been defined variously. Some refer to it as growth that results in significant poverty reduction, thereby benefiting the poor and improving their access to opportunities (e.g., UN 2000, World Bank 2000, and OECD 2001). But it is not clear how significant a reduction in poverty must be and how progress in achieving pro-poor growth is to be monitored. Others equate pro-poor growth with high elasticity of poverty with respect to growth (e.g., Ravallion and Datt 2002), but this still begs the questions of measuring and monitoring. Ravallion and Chen (2003) also introduce the concept of "mean growth rate of the poor", which seems analytically ambiguous.

Klasen (2001, 2002) similarly defines "pro-poor growth to mean that the poor benefit disproportionately from economic growth." In this definition of pro-poor growth there is the joint consideration of growth and its distribution. From a policy or operational standpoint, the method presented by Klasen (2001) suggests that in the design of a growth strategy or programmatic approach, a minimum objective should be to maximize the pro-poor growth index by minimizing any regressive distributional consequences. This signals a clear departure from the trickle-down development notion of the 1950s and 1960s that meant a gradual top-down flow from the rich to the poor. However, the idea is no longer so robust.

Pro-poor policies that that are infused in the basic policy package of private property rights, fiscal discipline, macro stability, and openness to trade increases the income of the poor to the same extent that it increases the income of the other households in society (Klasen 2001). It is not necessarily a process of "trickle-down," which suggests some sequencing by which the non-poor get richer first and eventually benefits trickle down to the poor. The evidence, to the contrary, is that private property rights, stability, and openness directly and contemporaneously create a good environment for poor households to increase their production and income. Pro-poor growth requires that the mean incomes of the poor rise faster than overall average incomes. A poverty reduction strategy that aims for less would not be worthy of its name and basically tantamount to a trickle-down development strategy.

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

Broad-Based Growth

Other economists have argued that it is also necessary to analyse the critical pathways by which broad-based growth leads to poverty reduction instead of focusing on only pro poor policies. Therefore, a government's expenditure items should not have the aim of reducing poverty directly. Rather, they must initially contribute to an expansion of GDP, and the resultant increase in savings would lead to poverty reduction through fiscal, financial and various other routes. They argue that if this is successful, the scale of poverty reduction is greater than focusing on pro-poor policies. Here, it is necessary to evaluate the scale of poverty reduction by calculating its cumulative total, in terms of present value and throughout the entire stream of time.

Dollar and Kraay (2000) have been supporters of a move towards shared growth. They used cross sectional data of from 65 countries in the 1980s and 1990s focusing on their growth and poverty experiences, with the poor being defined as the bottom fifth of the income distribution – the poorest 20 percent. Their conclusion was that on average the income of the poor rises one for one with overall growth, i.e. most growth has given all income groups roughly proportionate increases in their incomes. The World Bank and others have used this headline conclusion, in a somewhat traduced form, to show that 'a rising tide lifts all boats'. Growth *a priori* reduces poverty.

This has received some criticisms; key among them being that Dollar and Kraay's work has been used by some to avoid questions about the *nature* of the forms of growth and the existence of different growth paths with different poverty reduction outcomes. If growth reduces poverty in a one to one relationship the question then becomes 'how can we increase the speed of growth?' In their focus on the average they do not address this complexity, or ask questions about the causes of differences among different poor countries. They have also been accused of encouraging an excessively laissez faire approach to policy making in dealing with the poverty reducing aspects of growth. If growth reduces poverty as a matter of course, then there is no need to ask questions about how you can make growth 'pro-poor'. Dollar and Kraay ignore questions of the role of policy making and the debate around poverty, inequality and distribution.

High growth, however, is not a sufficient condition for poverty reduction; the pattern and sources of growth as well as the manner in which its benefits are distributed are equally important from the point of view of achieving the goal of poverty reduction. Currently, we seem to have gone full circle, moving from the 50s and 60s where countries aimed for an economic growth of 5 percent of the GDP in the assumption that the benefits of such growth would reach all sectors to this present time where the emphasis is on human resource development and the provision of basic needs as a possible way to effect overall growth in the long term. In spite of these, the informal economy continues to expand as the formal sector is unable to absorb excess labour.

Contribution of the Informal Economy to Economic Growth

The significance of the informal economy to domestic production and its growth is by now not in doubt in most SSA African countries. Neither is its significance as a source of employment and an important instrument in poverty reduction. There is no doubt that total demand in the economy is influenced by the informal economy, but by how much? What is the scope for boosting consumption in a typical African economy through the informal economy? What is not so clear are the channels used and how they interact. What causes what?

There are many things that we need to know about the informal economy that we do not yet know. In order to fully measure and value the contribution of the informal economy
to GDP, there is an urgent need for

- better estimates of contribution of informal economy to GDP and the means for achieving this contribution;
- estimates of contribution of informal employment in formal firms to GDP;
- estimates of contribution of informal employment in global value chains to GDP;
- estimates of contribution of informality in agriculture to GDP;
- estimates of contribution of secondary informal activities to GDP.

Due to the difficulties in measuring the contribution of the informal economy to the national income as well as the lack of relevant statistics, empirical evidence on the exact contribution of informal activities to national output is difficult to obtain. According to the ILO (2002), the informal economy's contribution to non-agricultural gross domestic product amounted to 45 percent in India, 31 percent in Indonesia, 32 percent in the Philippines and 17 percent in the Republic of Korea, during the 1990s. Also, Charmes (1999) estimates that the informal economy accounts for 27 percent of GDP of all Sub-Saharan African countries and nearly 20 percent of total employment. The sector's importance is evident in both the agricultural and non-agricultural sector. It accounts for nearly 41 percent of non-agricultural GDP and approximately 77 percent of non-agricultural employment (Charmes, 1999).

Table 2: Contribution of the Informal economy to Non-Agricultural GDP

Country (year)	Informal sector GDP as percentage of non-agricultural GDP
Africa	
Northern Africa	***27***
Algeria (1997)	26
Morocco (1986)	31
Tunisia (1995)	23
Sub-Saharan Africa	***41***
Benin (1993)	43
Burkina Faso (1992)	36
Burundi (1996)	44
Cameroon (1995-96)	42
Chad (1993)	45
Côte d'Ivoire (1995)	30
Ghana (1988)	58
Guinea Bissau (1995)	30
Kenya (1999)	25
Mali (1989)	42
Mozambique (1994)	39
Niger (1995)	54
Senegal (1991)	41
Tanzania (1991)	43
Togo (1995)	55
Zambia (1998)	24
Latin America	**29**
Colombia (1992)	25
Mexico (1998)	13
Peru (1979)	49
Asia	**31**
India (1990-91)	45
Indonesia (1998)	31
Philippines (1995)	32
Republic of Korea (1995)	17

Source: ILO 2002 Women and Men in the Informal Economy: A Statistical Picture. Data prepared by Jacques Charmes.

According to the International Labour Organization, approximately 85 percent of all new employment opportunities around the world are created in the informal economy. In some countries, employment in the urban informal economy has risen sharply over the past decade. Lithuania, for example, experienced a 70 percent increase in urban informal employment as a percentage of total employment between 1997 and 2000. The Economic Commission for Latin America and the Caribbean estimates that urban informal employment in that region increased from 43 percent in 1990 to 48.4 percent in 1999.

Box 1: The Informal Economy and Employment in Ghana

Following the Structural Adjustment process in Ghana, the percentage of public sector workers has continuously declined from around 13 percent in 1991/92 to 9.4 percent in the late 1990s and only 9.0 percent in 2005/06. This has been accompanied by an increase in the private sector, both formal and informal. For instance, the percentage of individuals working in the private sector as wage employees went up from 7.8 percent in 1991/92 to 14.5 percent in 2005/06 (Table 3). A substantial increase given the underdevelopment of the private sector in Ghana. In Accra, the capital, private formal sector work reaches almost a quarter of the working population with the rest absorbed in the informal economy.

Table 3: Shares of Employment by Type of Employment 1991/2006

Status of Employment		*Share*	
	1991/92	**1998/99**	**2005/06**
Wage Public	13.1	9.4	9.0
Wage Private Formal	4.9	4.9	8.4
Wage Private Informal	2.9	2.8	6.1
Self-Employment Agricultural	44.6	44.0	40.3
Self-Employment Non-Agric.	34.6	38.9	36.1
Total	100.0	100.0	100.0

Source: Coulombe and Wodon, 2007 (based on Ghana GLSS data)

There have been a number of recent studies into the nature of the relationship between economic growth and informal economy. Heintz and Pollin (2002) consider the relationship between the rise of informalisation and the corresponding ascendancy of neo-liberal policies in developing countries, focusing in particular on how the decline in average per capita GDP growth associated with neo-liberalism in the 1980s and 1990s fostered informalisation. They examine policy measures in two areas: raising the rate of economic growth and improving the regulation of labour markets. The study is based on findings from 20 countries in Asia, Africa, and Latin America. For each of the countries, the rate of change in informalisation is compared to the average per capita GDP growth (Heintz and Pollin 2003). Most of the countries (14 out of 20) experienced growth in informalisation, while four experienced a decline and two experienced little, if any, change. What is interesting to note is that informalisation increased in three countries with respectable per capita growth rates (>2 percent) and declined in two countries with poor per capita growth rates (<1 percent).

Based on these patterns, Heintz and Pollin (2002) have suggested that, contrary to common assumptions that informal employment results from underdevelopment and poor economic performance:

- 'Informal employment has been increasing faster than formal employment, even in countries with strong rates of growth.'
- 'Higher rates of growth are generally associated with smaller increases in the rate of informalisation.'
- 'At very high levels of growth, informalisation may decline.' (Heintz, 2006.)

Heintz and Pollin (2003) explain this pattern by the fact that high levels of growth driven by export production may increase certain types of informal employment: notably, industrial outwork for global supply chains (as in Tunisia during the 1990s). Sub-contracted work linked to the global production system — expands during periods of economic growth, especially when growth is driven by trade and financial liberalisation.

The suggestion about a close relationship between the formal and informal economies is very similar to the points made by Keith Hart (2008) about the origins and progression of informality. There are indications that in many economies, the formal economy is entering into a symbiotic relationship with the informal, where the former makes use of the latter to improve profits and growth strategies, perhaps even to avoid respecting labour standards and regulations. In many countries it was only after a sustained period of higher levels of growth that aggregate informalisation declined (Heintz, 2006.)

Based on the observations of several studies (Charmes 1998) there is a growing view that different countries demonstrate significant variation in their patterns of informalisation; while, in sum, sharp economic downturns may be associated with an expansion of the informal economy, in some countries, it is steady rates of economic growth that are associated with an expansion of the informal economy. Long-term high rates of economic growth are in most countries associated with either decline in informalisation or slower rate of growth of informalisation.

There is also the widely held view that different segments of the informal economy demonstrate substantial variation in their cyclical patterns. Certain segments of the informal economy may expand during downturns in the economy as the economic agents pursue survival activities and also as formal firms engage in more sub-contracting and outsourced activities as a way of coping with recession. There are segments of the informal economy that expand during upturns in the economy, and these are mainly dynamic independent enterprises and informal operators that receive sub-contracts and outsourced activities as production is restructured with trade liberalization.

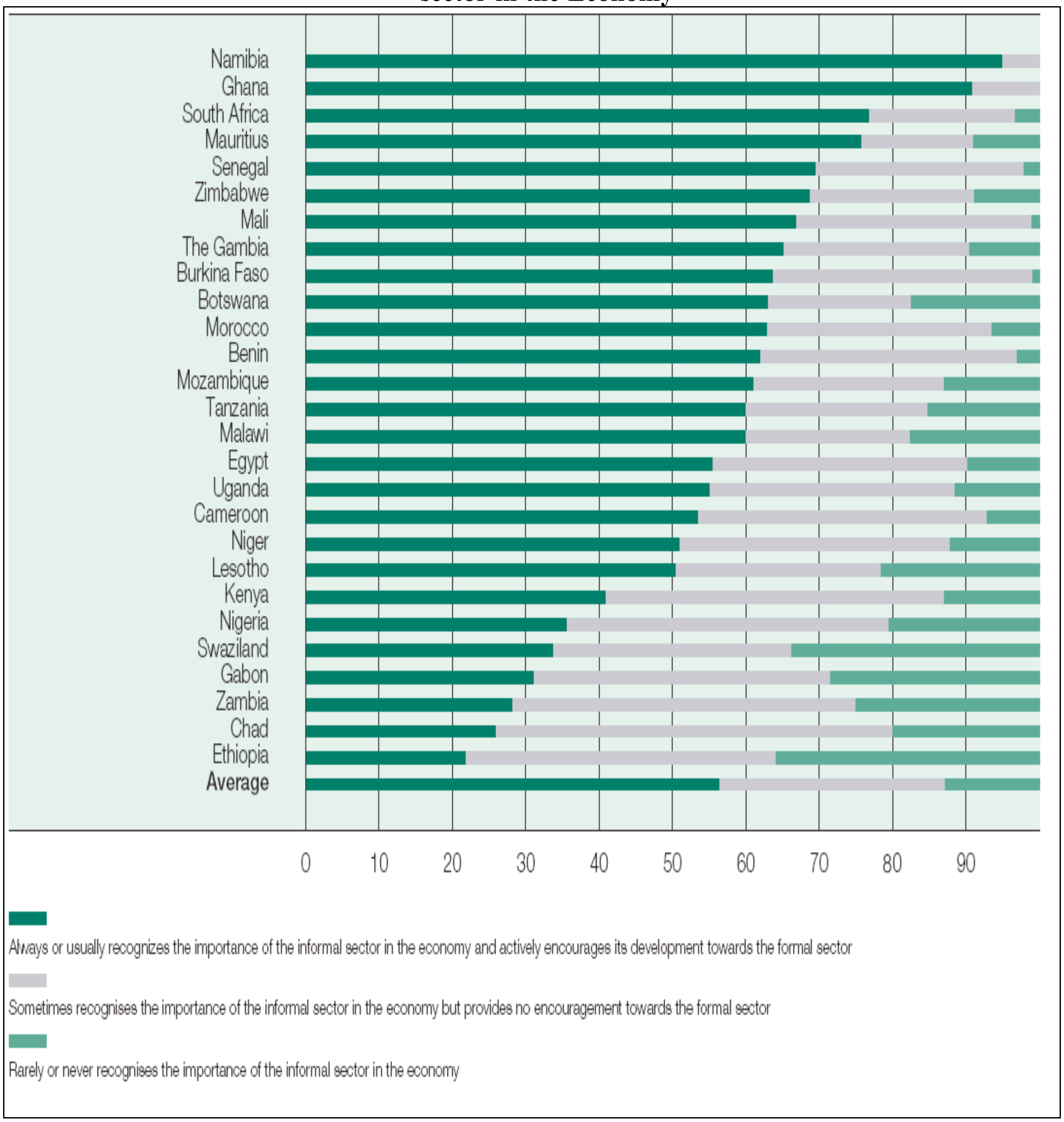
In terms of the cyclical patterns of informal activities, Charmes (1998) points out that there are two areas to focus, namely the share of informal enterprises in total enterprises and then the share of informal enterprises in total employment. The share of informal enterprises (in total enterprises) is generally seen to be counter-cyclical as the share of informal enterprises tends to go down as GDP per capita goes up. On the other hand, the output of dynamic informal enterprises tends to be pro-cyclical: that is, dynamic informal enterprises tend to grow as the economy grows. On employment, Charmes (1998) suggests that there is no clear correlation between growth in GDP per capita and the share of informal employment in total employment. The work suggests that sub-contracted work or industrial outwork portrays a mixed picture as it is associated both with low growth and economic downturns as well as with trade liberalization and global production.

Attitudes towards the Informal Economy

A report by the Economic Commission for Africa (2005), covering a survey of 27 countries, which used instruments developed by the ECA to assess the perception of governance by households and experts at the country level, showed that an average of 56% of the experts surveyed reported that the government always or usually recognised the importance of the informal economy and actively encourages its development towards the formal sector. Also, 31% were of the view that the government sometimes recognised the importance of the sector but provides no encouragement for its development, and 13% felt that the government rarely or never recognised the importance of the informal economy (Figure 2).

In contrast to the view that the informal economy is transitional in nature, recent evidence seems to indicate that it may be more of a long term feature of developing economies (Bekkers and Stoffers, 1995; Charmes, 2000), particularly in Africa and Latin America where there seem to be expansionary tendencies. As earlier mentioned, the role of the informal economy in SSA economies towards private investment growth, generation of employment and incomes, and poverty reduction cannot be overemphasized. However, despite this great contribution of the informal economy in SSA economies, some literature suggests that developing economies may stand to gain more if they make inroads in formalizing the informal economy. The next section reviews this in the light of new evidence across the world.

Figure 3: Expert opinion on whether governments recognise the importance of the informal sector in the Economy



Source: ECA governance survey of experts, 2005

5. The Informal Economy, Poverty and Inequality

Does working in the informal economy make one poor? Alternatively, does the informal economy attract only the poor? Poverty is one of the most serious problems faced by developing countries and a number of economies in transition. Although considerable progress has been made by a number of countries towards the MDG of halving poverty by 2015, global estimates suggest that about 1.2 billion people live on less than $1 a day. The vast majority of this population are the working poor, many of whom work in the informal economy. Indeed, the problem of poverty cannot be solved without paying closer attention to the informal economy and its participants.

The main contribution that the informal economy makes to poverty reduction is through the employment channel. The lack of employment opportunities in the public sector and in the private formal sector has forced many to seek jobs in the informal economy in order to earn a living. Although their earnings remain low and a large number of them are classified as poor, the informal economy allows them an alternative source of livelihood.

Poverty and Inequality

There is the general understanding that poverty and inequality are increasing across the globe. Poverty and inequality are worsening in parts of Europe, Central Asia and in some 40 African countries. It is well noting however that between 1960 and 1980 there was a pronounced decline in the inequality in life expectancy across countries due to the global spread of health technology and to major public health efforts in some of the world's highest mortality areas. Since 1990, however, HIV/AIDS (predominantly in many African countries) and a rise in mortality rates in transition economies (largely in Eastern Europe and Central Asia) have set back some of the earlier gains. Because of the AIDS crisis, life expectancy at birth has fallen dramatically in some of the world's poorest countries, sharply increasing the differences between them and richer societies.

Although global inequality measurements differ and is the source of many debates among development economists, according to the World Bank, "global inequality has steadily increased over the long run". According to the World Development Report of 2006, on a global level, inequality among nations is very wide. There are large differences in education and health, as well as access to infrastructure and other public services. For example the mean annual consumption expenditures range from Purchasing Power Parity (PPP) $279 in Nigeria to PPP $17,232 in Luxembourg (WDR, 2006).

The increases are in part a result of natural disasters, rooted often in environmental stress caused by earlier generations of poverty. Also, falling aid budgets in the 1990s and the increasing burden of international debt suffered by the poorest countries are leading to a more inequitable world. Other trends, such as the rapid pace and spread of information technologies, carry a risk of increasing global division, with the poorest countries unable to take advantage of these new areas of economic growth.

Poverty and Informality

There are opposing views regarding the relationship between poverty and the informal economy. From the definition of the informal economy, it may be suggested on the one hand that people who participate in that sector are trapped in the vicious cycle of poverty. On the other hand, the sector is seen as a transitory one serving as a channel for those with the intention of moving up the ladder financially at a later stage. The informal economy offers jobs that are of low quality, have poor employment and working conditions and therefore do not contribute much to poverty reduction (see Table 4). Often workers in this area are poorly remunerated, underemployed, have no social protection; their rights are less respected, and they are excluded from social dialogue and decision making. This makes them more vulnerable to shocks. For instance, in the event of an illness they have no protection or safety net to assist them (ILO, 2003). Thus, it may be inferred that there is a dual relationship between poverty and informality, i.e. that poverty forces people to engage in informality and working in the informal economy means poverty.

As Charmes (1998) and Sethuraman (1988) have indicated there is indeed an overlap between working in the informal economy and being poor as average incomes and wages in the informal economy are lower than average income and wages in the formal economy. A greater proportion of workers in the informal economy, relative to the formal economy, are from poor households, and a greater proportion of household income in poor households, than in non-poor households, comes from informal activities. But there is no simple relationship between working in the informal economy and being poor or working in the formal economy and escaping poverty.

Charmes (1998) and Sethuraman (1998) have both suggested that understanding and measuring the relationship between informality and poverty is complicated by a number of factors. A major constraint is the fact that different units of measurement are employed for the two concepts. Employment status and earnings are measured and reported at the individual level while poverty is generally measured at the household level. Another complication arises from the differences within the informal economy as the relationship between informal work and low earnings appears only when informal workers are analyzed by sector, status of employment, and sex/ethnicity/geography. Many studies have also shown that the relationship between informal work and household poverty appears only when other factors are taken into account showing the differences in households. These include the composition, headship, and dependency ratio of household; number and type of household income sources; and education levels of adults in household. But there may also be differences between individuals within households and these introduce their own complications in analysis. Charmes (1998) has suggested that the relationship between informal work, household poverty, and individual poverty appears only when intra-household dynamics are also analyzed.

By comparing some of the dimensions of employment and working conditions of the formal and informal economy Coulombe and Wodon (2007) reveal that on average, since 1991/92 to 2005/06, public sector wage earners in Ghana have enjoyed the best salaries, followed by workers from the private formal sector and the self-employed in non-agricultural activities. Self-employed farmers are still at the bottom of the scale in terms of earnings; slightly less than a third of the earnings of public sector workers (Table 4). The agricultural sector employs about 60 percent of the working population in Ghana; hence this analysis clearly shows that in the absence of the informal sector the poverty situation in Ghana would have been worse. According to the most recent household survey, the fifth Ghana Living Standards Survey (GLSS-5), the proportion of people defined as poor declined from 51.7 percent in 1991/92 to 39.35 percent in 1998/99 to 28.5 percent in 2005/06. Extreme poverty also fell from 36.4 percent in 1991/92 to 26.8 percent in 1998/99 to 18.2 percent in 2005/06. This means that in spite of the size of the informal economy, the proportion of people who live on less than $1 a day has declined.

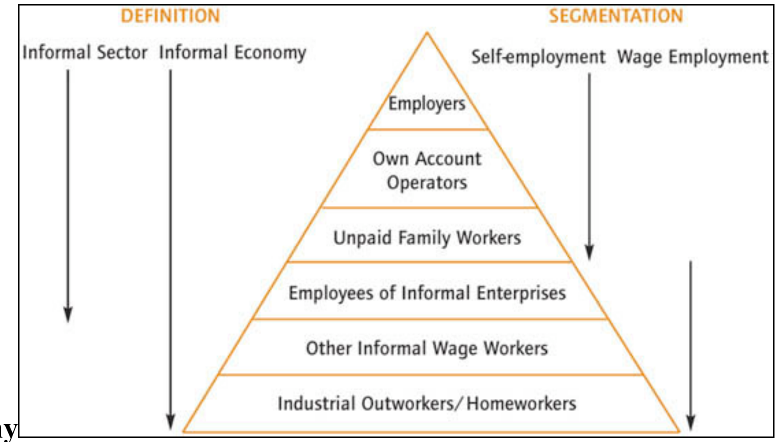
Table 4: Average Annual Earnings (in '000 GH Cedis, Accra January 2006 prices)

Status of Employment	*Earnings*		
	1991/92	**1998/99**	**2005/06**
Wage public	8790	11388	16968
Wage Private Formal	7768	9067	12241
Wage Private Informal	5513	4816	7642
Self-Employment Agricultural	2696	2730	5077
Self-Employment Non-Agric.	7122	7174	10271

Source: Coulombe and Wodon, 2007 (based on Ghana GLSS data)

The existence of a hierarchical structure of earnings in the informal economy has been documented by a number of researchers including Charmes (1998), Sethuraman (1998) and Chen et.al. (2005). Studies done by Charmes (1998) report that average incomes of micro-entrepreneurs tend to be higher than the legal minimum wage in the countries studied. At the same time the average wages paid to the employees of micro-enterprises tend to be near or below the legal minimum wage. The average earnings from own account activities and family businesses tend to be near or below the legal minimum wage, with some exceptions. The studies also show that average wages paid to casual day labourers tend to be lower than the legal minimum wage while the average piece-rates paid to industrial outworkers tend to be far lower than the legal minimum wage. Figure 2 below shows the different segments of the informal economy. This is in terms of the order of average earnings by segment. It shows informal employers at the top and casual and unpaid family workers at the bottom of the informal "pyramid". Also at the base are home workers and industrial out-workers who are predominantly female (Chen et al. 2004). It is reported by Steel (2008) as well as by Chen et.al (2005) that the relative sizes and earnings of these categories vary by country.

Figure 4: Definition and Segmentation of the Informal Economy



Source: Chen et al., 2005

As reflected in Figure 4 above, there is considerable gender segmentation within the informal economy. Chen et.al (2005) reported that women were over-represented in the informal economy in most regions such that, a greater share of the female workforce than the male workforce was to be found in the informal economy. The majority of women in the informal economy are usually own account operators, casual wage workers, industrial outworkers, and unpaid contributing family workers. Only a few are employers who hire others. Chen et.al. (2005) show that men and women are usually involved in different activities or tasks, even within the same sectors and statuses. The differences are also reflected by gaps in earnings within the informal economy (Chen et.al 2005). Indeed the gender gap in average earnings/wages is reported to be higher in the informal economy than in the formal economy and exists even within self-employment. Chen has attributed the relatively large gender gap in earnings/wages in the informal economy to two interrelated factors, namely that average earnings tend to decline as one moves down the employment status hierarchy within the informal economy, and secondly that women worldwide are under-represented in high-earning statuses (usually as employers) and over-represented in low-earning statuses (usually as industrial outworkers).

6. Is Formalizing the Informal Economy a Precursor to Faster Growth?

Some studies have argued that formalising the informal economy is precursor to faster growth since informality impedes investment and growth. This position is born out of the view that businesses in the informal economy often operate outside the tax and regulatory net, and therefore have difficulty in accessing credit, which in turn limits the scale of their operations and their ability to exploit investment opportunities. In addition, the informal economic activity undermines the ability of governments to raise revenue and therefore denies the public sector resources that would otherwise play a complementary role to private investment through infrastructural development or facilitation of business environment (Loayza, 1996). Furthermore, the existence of the informal economy is seen to threaten the collapse of the formal economy as enterprises in the latter mimic the informal economy in the invasion of taxes. Essentially, this development is seen to completely erode competitiveness since the remaining formal economy shoulders the tax burden as the informal economy evades taxes.

For analysts who see the evidence that the informal economy plays an important role in economic development, but is handicapped by its structure and circumstances, the logical thing is to call for its formalization. They see formalization as a genuine necessity. However, several studies have reported factors that impede the formalisation of the informal economy emphasizing the high costs of formalisation and the lack of incentives for operating in the formal sector. There have been various strategies some of which have been adopted by stakeholders in order to overcome these problems. This section simply documents various approaches and their associated weaknesses in the informality/ formality trade-off.

Cost of Formalisation

1. Opportunity costs

The most pertinent opportunity cost associated with the informal economy is the fact that informality perhaps discourages investment and undermines competitiveness due to a low-productivity trap that many in that sector are caught in (Palmade and Anayiotos 2005). Being informal affords enterprises the alternative of being less productive, as the cost of complying with regulations and paying taxes are avoided (Kenyon and Kapaz, 2005). Inadequate access to financial services and new technologies further limits their ability to be profitable and efficient. Although some may argue that informal businesses grow and formalize, they do not always do that when they find themselves in an informality trap. Their only competitive edge when compared to their formal counterparts becomes their ability to evade some taxes and avoidance of other regulations.

In a nutshell the opportunity costs can be represented by some of the conditions that those who work in the informal economy and their enterprises generally have to accept such as:

- Absence of official protection, recognition, and union organization
- Isolation from the social security system, including minimum wages and fringe benefit institutions
- Primarily self-employment work with low income and wages, and poor job security
- Low entry barriers to, unregulated and competitive, markets
- Small scale operation with individual or family ownership
- Labour intensive and adapted technology
- Reliance on locally available resources
- Lacking access to institutional credit or other supports and protections
- Unauthorized use of vacant public or private land

2. High Entry Costs

The informal economy is seen as infinitely expandable with low barriers to entry and few capital inputs (Fields, 2006). Formalization costs include entry costs such as registration and licence fees, compliance with regulations, and paying taxes (Straub 2005). Important regulatory areas that may increase the cost of formalization include those concerning the initial establishment and on-going operation of enterprises, property rights, and employment relationships, such as the indirect costs of respecting the rights and protection of workers (ILO, 2002). For instance, when a firm decides to become formal, it has to begin the process of registering as a company and pay a licence fee which may consist of a long list of procedures (including, screening, health and safety certificates, and registration with statistical offices, local authorities and respective ministries). The number of procedures and the level of efficiency among the offices involved in the registration process differ from country to country.

According to the *Doing Business Report for 2008* by the World Bank, many countries have seen a considerable regulatory reform in the past five years. Between April 2006 and June 2007, 200 reforms were introduced in 98 countries. Reforms to ease the entry of new firms were implemented in 39 countries; which will reduce the cost of entry to new businesses and encourage informal businesses to formalize. Ghana and Kenya are amongst the top reformers in Africa. Ghana reformed trade, tax, and property administration. It introduced a single window clearance process at customs where traders can now file all paperwork at one place. Clearance time dropped from seven days to three days for imports and from four days to two days for exports. While Africa performed well in reforming the business climate, the continent still lags behind other regions in its overall rankings under the Doing Business index. Inefficiency and corruption are part of the explanation for why less developed countries, have more procedures which are uncoordinated, more time consuming and require more resources for registering a business (Djankov et al., 2002).

3. Inadequate Access to Financial Services

In developing countries, the majority of Medium to Small Scale Enterprises (MSEs) lack access to formal financial services. Such firms rely on funds from micro-finance institutions or non-bank financial institutions. These funds are often much less than those that can be accessed from the formal institutions (Kappel et al., 2004). As a result, such firms are unable to make profitable investments. Much has been written about microcredit provision and much has been written about informal finance. The microcredit providers do engage the informal economy on a significant scale in terms of the proportion of their loans going to clients that acknowledge informal characteristics. As yet there is very little evidence of microcredit clients progressing towards more formal characteristics. Indeed, microcredit borrowing does not necessarily or naturally mean formalization.

It is expedient to say that there are some clear barriers to entry to the formal sector. These will take considerable efforts from governments to create the environment necessary for this to happen. The informal economy will continue to flourish as more people lose jobs in the formal economy. This situation is partly the result of economic necessity of the poor and the ease of entry and exit of informal businesses (Nelson and De Bruijn, 2005). While formalization may be considered desirable, it may also risk damaging fragile enterprises and livelihoods. In the subsequent section, alternative policy actions will be considered as a means to engage the informal economy in more productive activities.

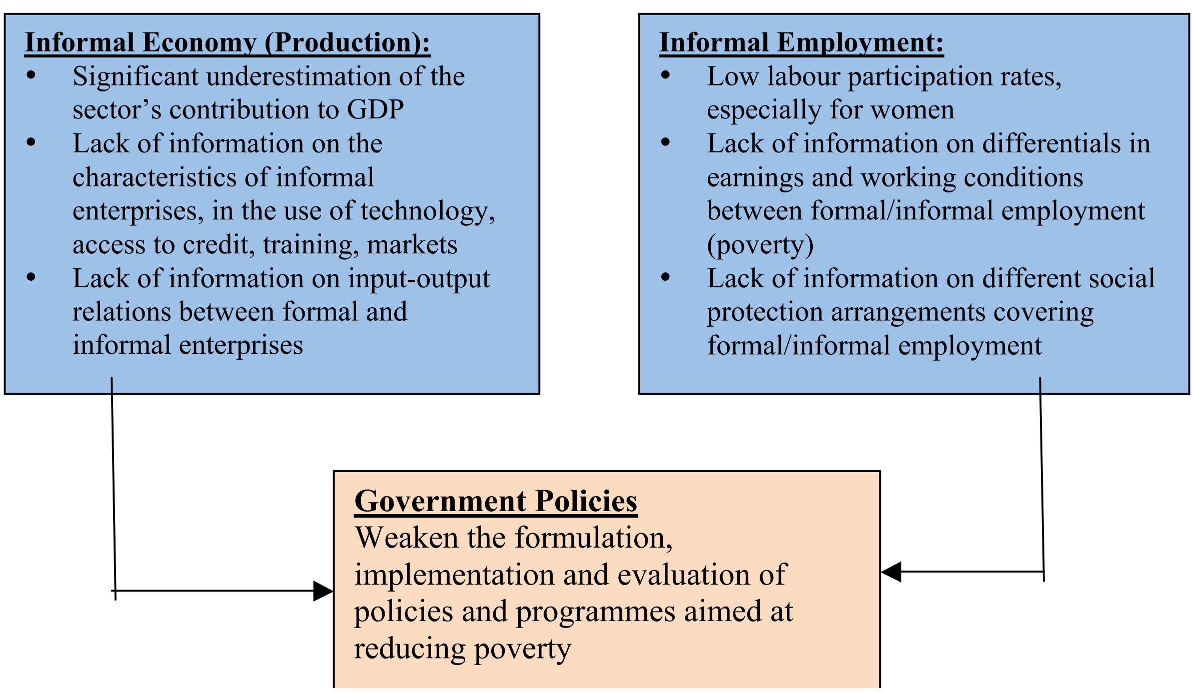
7. Strategic Options for Engaging the Informal Economy

1. Policy options

The question often posed is 'what can be done about the informal economy'? As markets fail to allocate resource more efficiently, it is important for policies to be formulated to deal with the problems of high unemployment; lawlessness and tax evasion that are often associated with the informal economy. There is the need to expand the economic participation of marginalised work-seekers and reduce economic uncertainty in poor people's lives. Hence, the state becomes more important in mediating these actions through industrial policy, macroeconomic policy and social protection policies. The state can generate employment directly, or subsidise employment through social protection measures or incentives. There are also macro-economic interventions related to raising demand for certain types of goods and services, such as infrastructure investment, exchange rate management, or fiscal policy management that is more supportive of businesses.

Some policies are aimed directly at the specific issue, be it reducing barriers to entry and asset accumulation for small firms, or raising wages and work conditions for vulnerable workers. However, the overarching environment in which informal activity takes place must also be understood, or micro economic interventions will have less impact (Figure 4). The informal economy has not been accorded the recognition that it deserves justified on grounds of the difficulties in the measurement and quantification of the informal activities. The main key to increase the participation of informal enterprises in the formal economy is the reduction in the magnitude of factors that limit their growth (Becker, 2004; Tokman, 2001; Morrison, 1995). For instance, the provision of title deeds offers poor people the right to use their properties in efficient and legally secured market transactions (De Soto, 2001). Countries must therefore adopt explicit and comprehensive policies and programmes to encourage the development of the informal economy.

Figure 5: Government policies, informal economy and informal employment



2. Private sector development

Private sector development is crucial for growth, development and employment creation in Africa. This is being recognised by donors in their support programmes for the private sector. Both in agriculture and in other sectors, much private sector activity in developing countries lies outside the formal economy. Of all the non-agricultural private actors in Sub-Saharan Africa and Asia, an estimated 70–80 percent is in the informal economy (UNDP 2004c). SMEs also play an important role in Africa's economies (GDP and employment), although cross-country and micro-level research is not conclusive on the causal link between SMEs and economic development. However, growth depends on all types of firms equally, small and large. Since, smaller firms may face larger and different growth constraints, which might explain the size of SMEs' contribution to growth, there is the need for a targeted or at least different approach. Many of the binding constraints are due to the presence of market and government failures. Indeed, public support for private sector development (PSD) is justified when markets fail to allocate resources efficiently. Public support can also fail, and it can be market distorting or favouring individual firms more than others, which raises doubts about the ability of governments to fine-tune the market. What is needed is a creation of an enabling environment for the private sector, defined by policies, laws and regulations affecting private sector development.

Failure to attract firms to formal market activities results in foregone tax revenues and serves to undermine the quality and coverage of public services (such as roads and education) and inhibit the transparency and confidence in markets (as firms pursue tax- and regulatory-avoidance strategies to survive). The close link between informality and poverty suggests that efforts should be focused on changing these dynamics. External sources of private capital, including venture capital, can promote developing country firms and entrepreneurs. The cost of providing such capital should be minimized by governments—not only to support physical investments but also because venture capitalists and other specialists in business development often provide important knowledge to indigenous firms. Markets alone will not solve the short-term needs of the most impoverished communities. Instead, for the poorest and most isolated communities, public finance and subsidies will have to create the conditions for market-based economic activity to thrive.

3. Promotion of Informal-Formal Economy Linkages

The informal economy directly or indirectly has linkages with the formal economy. When a more conducive environment is created for firms in the informal economy to participate in linkages with firms in the formal economy, they stand to benefit from access to reliable market, financial support, technology transfer and training and supervision. However, the majority of informal firms are excluded from these linkages. Measures which governments may take to promote linkages include: first, the reservation of a significant percentage of public orders for those micro, small and medium enterprises (MSME) that comply with the regulations. This may encourage increased formalisation of MSMEs. This can be done by increasing the number of suppliers and buyers linked to informal enterprises and excluding the middlemen who add no value to the transaction process. Sri Lanka for example, is considering establishing regional markets to enable farmers to sell directly to final buyers (Becker, 2004). This idea has been tried in Ghana where farmer markets have been set up to allow farmers to sell directly to customers but the activities of market queens and middlemen have hindered this process.

Currently, many countries have taken significant steps to support the informal economy as part of its overall support for the private sector. These Private Sector Development (PSD) initiatives include strengthening linkages between the informal and formal sectors in an environment that helps them to benefit from each other.

4. The Provision of Safety Nets

Participants in the informal economy enjoy little social protection against illness, disability, unemployment, old age or the death of a main income earner. Even the formal sector in most developing countries is unable to provide comprehensive social protection for its workers, as usually enjoyed in developed countries. Social insurance schemes, such as health insurance, disability allowances or retirement benefits, are often financed through a mix of taxation and contributions from employers and the formal workers themselves (Chen et al., 2002). ILO (2002) estimates that only 20 percent of the world's workers have what they describe as "truly adequate social protection" and more than half of the world's workers and their dependants are excluded from any type of formal social security protection. In sub-Saharan Africa and South Asia, formal social security personal coverage is estimated at 5 to 10 percent of the working population, and in some cases is decreasing.

There must be a way of providing social safety nets for people working in the informal economy since they are more vulnerable to economic shocks than those in the formal sector. However, given the nature of the informal economy, it is very difficult to implement programmes such as contributory unemployment benefits. Apart from high financial costs, the administration of social insurance schemes is very challenging. With social protection being increasingly considered as a right of workers, the informal economy poses a difficulty for policy-makers. Canagarajah and Sethuraman (2001) argue that, the current attempts to extend orthodox social protection measures to those in the informal economy in developing countries are therefore unlikely to succeed in providing effective protection.

5. Measurement Problems

Measurement of the size of the informal economy in terms of contribution to GDP and in terms of employment is important in its own right. Despite their importance, informal production and informal employment are poorly covered in official statistics, and less information is available on contribution to economic growth. The data collection is limited to ad-hoc studies such as establishment and labour force surveys which only capture a small fraction of those working in the informal economy or in unprotected jobs. Even in cases where data are available, they are often not comparable at the international level and collected on an ad-hoc basis thus hampering the construction of harmonized time series and comparative analysis among countries. Governments have acknowledged the importance of the informal economy in varying degrees across SSA but attention must be drawn to the need to have a more accurate picture of the informal economy and its contribution to economic development.

8. Conclusion

There are two opposing schools of thought concerning the role of the informal economy in economic growth; those who believe that the informal economy needs to be formalised and those who believe that it will continue to be a permanent feature. Institutional economics offers a framework for understanding how these institutions evolve within the context of general development. But it does not adequately look at changes that can take place in their roles and how cooperation between them affects the general outcomes. It is suggested here that under conditions of high unemployment and growing poverty, as is the case in SSA, the informal economy is likely to expand and should be viewed more positively with a view to enhancing its productivity by removing institutional obstacles to the achievement of higher productivity.

Indeed the perception that the presence of a huge informal economy constrains growth and investment is unsubstantiated. The informal economy has a role to play in generating incomes and wealth and the formal private market mechanism alone cannot be relied upon to solve the poverty and unemployment problems in SSA. If SSA is to make any significant progress towards achieving poverty reduction goals, policy must focus on informal economy strategies that encourage its participants to engage in the wider economy.

The quest to formalisation of enterprises needs to be addressed from various different angles; by reducing entry and operating formal costs, increasing the incentives for MSEs to operate formally, reducing obstacles to their growth, and searching for inexpensive approaches through which to enforce compliance with government regulations. The national tax system needs to be well structured, clear and transparent. Local levies may be transformed into fees for the use of community resources in order to encourage the efficient provision of local public services and accountability. Straightforward property right registration and efficient contract enforcement mechanisms which recognise and incorporate informal, popular rules need to be brought into the process of securing property rights. Dual labour regulations and safety nets are necessary to enable informal enterprises to meet part of their labour contributions while staying in business and offering employment. The introduction of dual safety nets for this purpose (whereby informal enterprises pay a certain percentage and the rest is covered by governments through their poverty reduction strategies) would be necessary. Informal enterprises may need to be sensitised to the need of improving employment and working conditions.

Contrary to the expectations of much of the early development literature, the informal economy has not only persisted but also grown in many developing countries, particularly in Africa. With increasing globalization and opening up of economies, as well as the current economic crises suggests that the informal economy will once again act as a safety net for the many that have been pushed out of formal employment. A key component of this agenda in Africa will be to improve the collection and analysis of data on the informal economy with the key objective of identifying segments in the informal market that can be targeted with appropriate policies.

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