

## The needs and potential of the informal economy in Sub-Saharan Africa

The informal economy is receiving increased attention from policymakers, as it provides jobs and income to many of Africa's poorest households. Yet, employment in the informal sector is vulnerable and income irregular. Furthermore, informal workers often lack social protection and long-term prospects. Crucial questions to be addressed are: How can (Dutch) development policies and programmes be more responsive to the needs and potential of the informal economy in Sub-Saharan Africa? And how can the informal sector create productive and decent jobs?

These questions guide the [online dossier on the informal sector](#) recently launched by INCLUDE. This policy brief follows up on a previous INCLUDE [policy brief](#) on the informal sector and synthesizes relevant resources from INCLUDE's research groups and knowledge base. It provides a **definition** of the informal economy as well as the **rationale** behind an enhanced policy focus on this sector. It also outlines the potential of **two policy approaches** for dealing with informality and formulates several **recommendations** to stimulate inclusive growth through informal sector development.

### What is the informal economy?

The informal economy is commonly distinguished from the formal economy by a number of characteristics:

- According to the [OECD](#), the informal sector is characterized by people (or 'units') who are engaged in the production of goods and services and who typically operate **"at a low level of organization, with little or no division between labour and capital as factors of production and on a small scale"**.
- These units can be identified at two levels:
  - **Enterprise level:** All enterprises that are **not registered under national laws**.
  - **Workers' level:** All employers and employees who are **living below a specified level of employment** and/or who are **unregistered**; labour relations at this level "are based mostly on **casual employment, kinship or personal and social relations** rather than contractual arrangements with formal guarantees".
- [CISLAC](#) further defines the informal sector as "the sum total of economic activity that happens **outside state regulation**, which is neither taxed nor represented in a country's GDP".
- The informal economy consists of several **informal, non-programmed segments**, in which producers co-exist next to modern, export-oriented producers. The distinction between the formal and informal economy is, therefore, not spatially or sectorally bounded.

Yet, in Sub-Saharan Africa the distinction between the formal and informal economy is not always clear cut. For instance, formal enterprises can hire informal employees or may have inputs supplied by informal businesses. According to [Floridi and Wagner](#), this dichotomy needs to be replaced by a view that recognizes the interaction between formal and informal economies in a 'borderland economy'. This view allows for the recognition of companies that are neither fully formal nor fully informal, known as 'transformational companies'.

### The rationale for an enhanced policy focus on informality

Due to low levels of organization and registration, it is difficult for policy institutions to recognize the specific needs of the informal economy in their policies and programmes. Yet, the **size** of the informal economy necessitates its recognition in development policies. [ILO](#) estimates that "the informal economy comprises half to three quarters of all non-agricultural employment in developing countries". In Africa, this share is increasing

because of Africa's '[youth bulge](#)', as youth are often unable to find jobs in the formal economy. Other reasons that justify the need for enhanced policy recognition are:

- [High levels of poverty and vulnerability](#): Women and youth are overrepresented in informal economic activities and are exposed more to poverty, instability and poor working conditions. Lack of structural long-term prospects may lead to frustration, social and political instability, and interregional and international migration.
- [Fragility of employment](#): Jobs in the informal sector are often unstable, uncertain and precarious, particularly because employment conditions are not regulated or regulations are not complied with. According to [ILO](#), some of the characteristics of informal employment are “lack of protection in the event of non-payment of wages, compulsory overtime or extra shifts, lay-offs without notice or compensation, unsafe working conditions and the absence of social benefits such as pensions, sick pay and health insurance”.
- [Low productivity](#): Informality leads to low productivity due to lack of physical and human capital and lagging investment.
- [A taxation gap](#): National governments lose a large amount of potential tax revenue due to the size of the informal economy, which inhibits public investment and undermines government legitimacy. Moreover, the taxation gap creates new, and reinforces existing, inequalities, as informal workers are excluded from any social contract with (and protection from) the state.

## Two policy approaches towards the informal economy

To tackle these challenges, two policy approaches to improving employment in the informal economy have emerged:

- Stimulate formal entrepreneurship in order to **facilitate the transition** of informal workers to more growth-generating activities
- Improve **rights and working conditions** (including social protection) for workers in the informal economy

### 1. Facilitating the transition towards formal entrepreneurship

ILO [Recommendation 204](#) (2015) focuses on stimulating the integration of informal workers in the formal economy by creating employment opportunities in the latter. In line with [recommendations from INCLUDE](#), ILO concludes that promoting employment in the formal sector requires an integrated approach aimed at promoting a **favourable business climate**, establishing appropriate **legislative and regulatory frameworks** (such as minimum wage policies), promoting the **organization of workers** to improve the social dialogue, increasing **access to financial and business services, markets, justice, education and healthcare**, and establishing **social protection floors**.

Compared to men, women face [additional constraints](#) in finding productive jobs. Therefore, policy must be geared towards improving **women's access and right to land**. Moreover, their **representation in collectives and policy dialogues** must be improved. Youth can benefit from an additional focus on [access to training](#) in relevant **skills** (including skills to set up businesses or to work in the [ICT sector](#)). ICT is considered vital to enabling new business models and formalizing traditionally informal activities. The INCLUDE research project '[The IT sector in Kenya](#)', led by Harry Barkema (EUR), focuses on the conditions in which small IT firms in Kenya, which typically start in the informal sector, take off, generate organizational growth, and become formal-sector employers of women and youth.

To encourage the formalization of businesses, one recommendation is to decrease transaction costs, such as by revising the requirements for the registration and administration of businesses, including reducing the costs involved. According to the [African Development Bank](#), by investing through informal channels, African entrepreneurs seek to reduce costs related to wages, retirement pensions, and other social benefits. For many

informal entrepreneurs, however, the threshold for registration (costs and the amount of documents required) to operate in the formal sector are [likely to remain too high](#).

Rather than making it cheaper for informal enterprises to formalize, attention has recently been given to [raising the cost of remaining informal](#), for example, by increasing the enforcement of existing regulations or [increasing the collection of tax revenue from the informal sector](#). However, such policies can increase the vulnerability of informal workers, who depend on their enterprise for survival. Moreover, formalization is viewed with suspicion by informal workers, due to high levels of corruption in many African countries. Indeed, a [2004 ILO study](#) found corruption to be the most important 'predictor' of informality. Therefore, **fighting corruption** may pay a double dividend: it may allow for more equitable taxation while also incentivizing entrepreneurs to formalize by themselves.

## 2. Protecting informal workers' rights

Yet, formalization itself should not be seen as a panacea or a reason to shift attention away from the informal economy. According to [Christopher Nshimbi](#), formalization policies should start with formal recognition, especially by government authorities, of informal cross-border traders, and the critical role they play in creating jobs, especially for women and youth, and their contribution to formal regional economic integration. More attention to their needs and rights is, therefore, crucial. Hence, a second policy focus should be geared towards **protecting informal workers' rights**, in particular those of [female informal \(cross-border\) traders](#).

Even when the rights of informal workers are promoted, laws and regulations are often not enforced. Moreover, informal workers are generally not (fully) aware of their rights and, as a result, do not take action to enforce their rights. Recognizing and increasing the role of **informal workers' organizations** and [trade unions](#) is crucial in this respect, [especially for women](#). This is also demonstrated by the INCLUDE research project '[Informal workers' political leverage](#)', led by Mayke Kaag (ASC), which investigates the role and impact of trade unions and informal workers' organizations in Ghana and Benin in promoting decent work for informal workers. To enhance the role of unions in the protection of informal workers, requires [recognition of local contexts](#), especially when it comes to the organization of women.

An innovative way of giving informal workers a voice in the policy reform process is being demonstrated in Uganda, where an [ILO project](#) supports radio stations to focusing on small business concerns and channelling their demands to policymakers, who respond via phone-in broadcasts.

Another approach is to [improve access to social protection](#) to enhance informal workers' resilience. Informal workers are not usually involved in social protection schemes (safety nets), such as health insurance and pensions. **Political commitment** is crucial to establishing an effective and coherent social protection structure that **also includes informal workers**. Policy should draw on the [ample promising examples](#), best practices, and innovative designs and implementation of social protection legislation in many African countries.

## Recommendations

To sum up, this policy brief makes the following recommendations to enhance policy responsiveness to the needs and potential of the informal economy:

- Recognize '**transformational companies**' as companies that bridge both formal and informal economies, instead of dichotomizing the two.
- **Reduce transaction costs** for formalizing businesses and align the associated transaction costs of formality and informality.
- Use integrated approaches to promote the transition to formality and focus on the specific constraints of vulnerable groups such as **youth and women**. These integrated approaches can entail additional

investment in **access to social protection, markets, financial and business services** (including access to information), **healthcare, justice, education** and **skills training**.

- **Skills training** should cover ICT skills, skills for diversifying labour activities, skills to facilitate formalization (including administration skills), and management and leadership skills.
- Recognize and support **informal workers' associations** and **cooperatives** and enlarge the **outreach of trade unions** to informal workers.
- Eliminate the **taxation gap** between the formal and informal economies (for instance, by simplifying the tax system and providing tax system education in the informal sector, as well as by increasing trust by fighting corruption through increased accountability and transparency).
- Acknowledge the **limited potential of formalization**. [According to field experiments](#), even when transaction costs are lowered or aligned, only a few informal companies formalize. Micro-credit can enhance entrepreneurship, but [seldom leads to formalization](#).

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