Africa Growth Initiative at BROOKINGS

POLICY BRIEF

The informal sector in francophone Africa

The other side of weak structural transformation

Nancy Benjamin and Ahmadou Aly Mbaye

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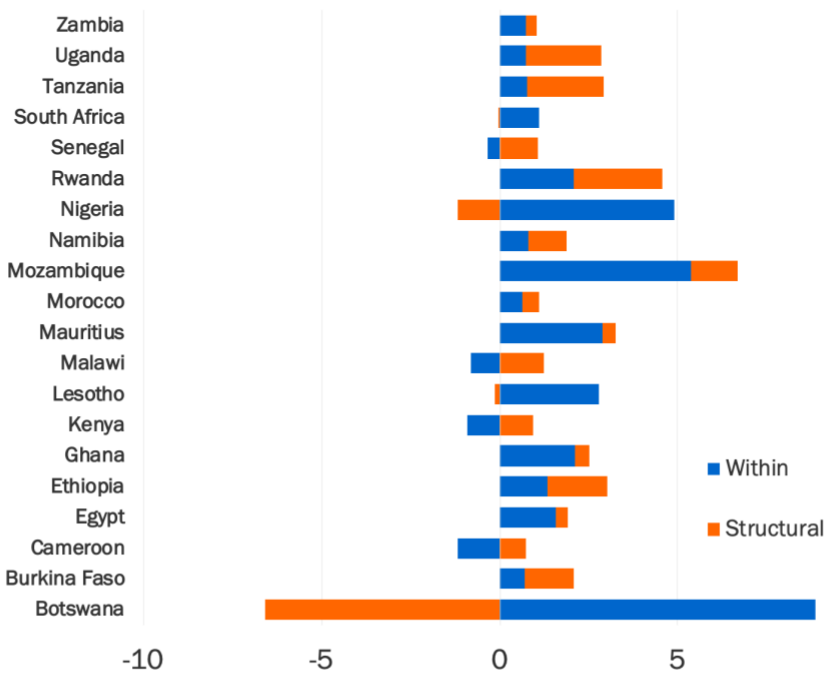
Abstract

This paper explores the relationship between slow structural transformation and the growth of the informal sector in francophone Africa, where formal firms and labor-intensive manufacturing have not grown as they did in Asia. We offer a set of explanations associated with the growth of the informal sector. At the same time we consider why formal-sector jobs remain limited, including high formal-sector wages relative to productivity, an unwelcoming business climate, and rent-seeking. High factor costs and policies that concentrate rents into a small number of hands reduce the incentives for modern, international firms to invest, which would provide an engine of modernization for the economy. Those who can neither afford the high input costs nor gain access to rents end up in the less productive informal sector, which necessarily absorbs the large number of new entrants into the labor force. The paper concludes with recommendations for policies that could accelerate structural transformation in francophone Africa.

INTRODUCTION

In many developing countries, rapid economic growth and poverty reduction have been the result of successful structural transformation—the shift of production from low to higher productivity sectors, mainly agriculture to manufacturing (Rodrik 2016). In African countries, unlike in Asia, there is little growth attributable to "between-sector" reallocation over the quarter century from 1990-2015; then again, as McMillan et al. 2014 point out, the sub-period of 2000-2010 saw an increase in the contribution of structural transformation to growth in Africa. For most countries in our sample (Benin, Burkina Faso, Cameroon, Senegal), the "within-sector" component of productivity growth is consistently higher than the "between-sector." For resource-rich countries like Nigeria and Mozambique, growth has been very high but very little structural transformation has occurred over the long run.

Figure 1: Structural change decomposition 1990 – 2010s



Source: Authors calculation from Penn World Tables (Groningen Growth and Development Center, 2019a).

The transformation that has occurred is a rapid rise in the share of the services sector. Yet, this sector's productivity is relatively low. One reason is that the service sector is dominated by small, informal firms. In fact, informal firms are the dominant employer in sub-Saharan Africa, accounting for half the value added in the continent, but, notably, these firms are much less productive than formal ones in the same sector.

This paper explores the relationship between slow structural transformation in Africa and the growth of the informal sector. The main reason for the former is that formal firms and labor-intensive manufacturing have not grown as they did in Asia. Several explanations have been put forward for this difference in the development trajectories of the two continents. McMillan et al. (2014) summarize and corroborate the main ones as: (i) many Asian countries, including China, Korea, and Taiwan, continued to protect their import-competing industries while preparing their exporting firms to enter world markets; (ii) these countries followed an undervalued exchange rate policy that favored tradable sectors, whereas many African countries have had overvalued exchange rates for long periods; (iii) many African countries are also natural resource exporters which, due to the Dutch disease, dampens the competitiveness of their manufactured exports.

In this paper, we offer a set of complementary explanations for the growth of the informal sector and lack of structural transformation in Africa: First, the high cost of inputs (electricity, wages, finance) as well as high taxes on businesses make it difficult for most firms to compete in international markets. Second, the few formal firms that survive do so under protection, which generates rents that are allocated to a limited number of beneficiaries. Those who cannot afford the high input costs nor gain access to rents end up in the informal sector, which necessarily absorbs the large number of new entrants into the labor force.

While comprehensive data on the informal sector is lacking, its growth can be inferred from the rise of the service sector. Table 1 shows that the counterpart of the declining share of agriculture in employment in Senegal, for instance, does not show up as a rise in manufacturing's share but rather as an increase in the share of services. Benjamin and Mbaye (2012) distinguish between large informal firms and small ones because their behavior and obstacles to investment differ markedly. While the vast majority of informal firms are very small, large informal firms play a major role in certain sub-sectors, such as food imports, pharmaceuticals, cement, construction, trucking, and other services. As detailed in case studies in Benjamin and Mbaye (2012), interviews and surveys in West Africa reveal that large informal firms, in particular, usually have fragile structures. They have sizeable sales and a large number of temporary workers but are run like a family firm insofar as they have a small number of permanent employees, no specialized departments—such as human resources or finance—and seldom survive the death of the owner or a falling-out with political patrons. A firm that chooses to be informal in a country with weak regulatory enforcement can become quite large and, as we show below, may have strong incentives to do so.

Indeed, both formal and informal firms need relationships of trust to secure inputs, get credit, and market their products. When formal institutions fail to provide effective property rights, informal firms can, to some extent, internalize these relationships of trust if they are large enough. Sometimes, becoming "large enough" can take the form of informal religious and ethnic networks. These networks can substitute for official institutions that, in developed countries, support arms-length trading in the formal sector (Golub and Hansen-Lewis 2012).

Table 1. Household survey employment estimates in Senegal (percent)

Sector	Formal/Informal	2011	2015
Agriculture	Formal	0.8	0.3
	Informal	55.1	36.1
Industry	Formal	2.8	1.3
	Informal	10.7	7.8
Trade	Formal	1.2	1.9
	Informal	16.5	18.0
Other services	Formal	2.5	5.6
	Informal	10.3	29.0
Total	Formal	7.4	9.1
	Informal	92.6	90.9

Source: Senegal Statistical Agency (ANSD 2011, 2015) and authors' calculations.

INFORMALITY, PRODUCTIVITY, AND EMPLOYMENT

Informal employment is overwhelming in Africa. By and large, the urban informal sector has open entry and provides employment for those leaving agriculture, who are the core migrants underlying structural transformation, as well as new entrants into the labor force from urban areas (Jedwab and Vollrath 2019). In addition, the informal economy employs most of its workers from vulnerable groups, including women and youth. Finally, the vast majority of small businesses and microenterprises operate in the informal economy. Inevitably, given the lower productivity of workers in the informal sector, their contribution to GDP is less than proportional to their numbers, but still large. Hence, the growth of the labor force, through rural–urban migration as well as high fertility rates, has been one of the most important determinants of the rise of informal labor force in the developing world.

Table 1 shows Senegal's employment in certain broad sector categories for 2011 and 2015, with estimates based on household surveys. The figures reflect the fundamental trend of structural transformation in Africa: The employment share declines in agriculture, but it also declines in other tradable goods sectors, namely, industry, while there is a concomitant rise in services. Using these employment figures alongside data on output of the formal and informal components of these sectors to make rough estimates of labor productivity, it appears that the gap between formal and informal productivity is growing over time in most sectors. The lower productivity in the informal sector also translates into lower earnings. Indeed, there are very large earnings differentials between formal and informal workers that are well documented across countries and geographical regions (see Gasparini and Tornarolli 2007, for example). High-paying public or formal sector jobs are protected, but also rationed. Thus, as the formal sector, which is dominated by the public sector, stagnates because of high wages, and poor and costly infrastructure (see below), the informal sector expands and economy-wide productivity growth drops.

Large informal firms have productivity levels that are usually between those of formal and small informal firms, although sometimes they can be even higher than that of formal firms. In general, the closer to formal a firm is, the higher productivity it tends to have (Benjamin and Mbaye (2012)). The fact that large informal firms' productivity sometimes rivals that of the formal sector confirms Gelb et al.'s (2009) finding that the institutional environment deters many firms from formalizing.

At the same time, large informal firms' modus operandi and organizational structure are not conducive to productivity growth. These features include weak management structures, lack of transparency, sub-optimal allocation of productive factors (including reliance on family sources for credit), and reliance on rents associated with political and social connections. Informality also inhibits modern management skills and worker training, limiting growth potential and access to the world market.

HOW IS RENT SEEKING SHAPING FACTOR COSTS IN AFRICA?

Production costs remain very high in Africa and well above those of comparator emerging economies by most measures. Likewise, the number of taxes affecting formal businesses, and the tax rates on business income, are generally high in African countries, although since they are applied to a very narrow base, tax revenue-to-GDP ratios remain quite low. Labor market regulations are often perceived as onerous. Furthermore, many of these nations face marked political instability and corruption.

Electricity prices in some African countries, as a ratio of GDP per capita, are some of the highest in the world. The combination of low reliability, poor quality, and high prices is a substantial impediment to investment. Moreover, the percentage of paved roads is low, inhibiting effective transport and access to markets.

Formal wages are high relative to productivity in West Africa, particularly compared to the major exporters of East Asia. Golub et al. (2018) study African competitiveness vis à vis China, proxying overall productivity by GDP per capita, given the unavailability of employment data. Compared to per capita GDP, manufacturing wages are very high in sub-Saharan Africa. For example, in 2010, most Asian countries, including China, had average annual manufacturing wages roughly equal to per capita income. The same is true in other regions. In sub-Saharan Africa, however, wages are typically several times per capita GDP. The exceptions are Mauritius and, to a lesser extent, South Africa.

Unsurprisingly, expensive infrastructure, high capital costs, and high formal sector wages lead to a large share of firms operating in the informal sector, where the main advantages are paying lower wages and lower taxes. Given the low international competitiveness revealed by the cross-country wage comparisons, export-oriented manufacturing production in Africa is almost non-existent. Formal firms are primarily foreign multinationals serving the domestic market. They have no choice but to pay formal wages and formal taxes, but they also benefit from import protection and other special advantages.

Mbaye, Golub, and English (2016) confirm that formal firms in Senegal in import-competing industries such as sugar, vegetable oil and wheat flour benefit from protected rents, either in the form of high import taxes, monopoly rights to import key inputs, or privileged access to government contracts. This is akin to the phenomenon of "tax bargaining" (Prichard 2015), exemplified by the saying often heard in development circles, "governments tax elites and elites tax the rest through high prices." Large informal firms often benefit from rent protection as well. In particular, where the regulatory regime distinguishes a legal, regulated segment of a sector, such as pharmaceuticals, large informal operators may benefit from protected rights to exploit the unregulated segment. For instance, the large informal firms get the protected rights to sell unregulated pharmaceuticals or unregulated transport services. In some cases, the informal participation of government officials in the business may help ensure this protection.

There are two main implications of these observations. First, the rents associated with protected sectors, even in poor countries, are worth the efforts of formal firms to capture a portion of them. Second, when certain firms have access to artificially high rents, labor will tend to demand its share (Azam 2001). Thus, high formal manufacturing wages, in part, reflect overall protected rents in the sector.

The message for entrepreneurs is clear: Either cultivate and capture rents or operate in the informal sector. The message for multinational firms is also clear: Do not come to these countries to manufacture with cheap labor because the formal labor is not cheap. The overall message is also a familiar one: Control of rents is more lucrative than raising productivity.

In sum, international competitiveness is hampered by a number of constraints. The business environment is generally hostile, and it can be nearly impossible to operate in the formal sector without political connections. Infrastructure and public services are poor, and factor costs are high. Competitive wages and eased labor market regulations, in addition to better infrastructure, are necessary to attract foreign investment in export-oriented manufacturing and other traded goods and services. Thus, formal firms in Africa are concentrated in protected import-competing sectors, and the export of labor-intensive manufactured goods are almost non-existent.

IMPLICATIONS FOR STRUCTURAL TRANSFORMATION

Structural transformation typically consists of workers migrating out of agriculture. Many, at first, move into manufacturing, and later increasingly into services as manufacturing plateaus. Evidence shows (Herrendorf, Rogerson and Valentinyi 2014) that, in today's developed countries, the plateau in manufacturing employment occurred at about the same level of GDP per capita as today's developing countries. However, the levelling off—or even contraction—of manufacturing is occurring at much lower levels of national income in Africa than for other developing countries (Rodrik 2016). The exodus from agriculture continues, but these migrating workers and new entrants largely end up in low-productivity informal manufacturing and services, and connections to the modern sector are not strong. Informal urban incomes exceed those of subsistence agriculture but are still well below formal sector earnings.

Many of the underlying problems come under the domain of governance and economic management. For example, West African governments have not been successful in providing reliable infrastructure at reasonable prices. The sagas of several network utilities provide abundant evidence that rent seeking interferes with service delivery (see, for example, Economist Intelligence Unit 2014). In the capital markets, poor contract enforcement leads to high borrowing costs. Similarly, government as the issuer of business licenses acts as the gatekeeper to formal, legal operations of firms in their countries, leading to high formal wages and stagnation of formal manufacturing. It also leads to a kind of dual regulatory regime where formal firms follow formal rules and informal firms, unable to meet these standards, are only partially regulated. Some institutional arrangements are designed specifically to accommodate informal firms, such as the presumptive tax regime that is practiced in most francophone African countries. However, loose enforcement of accounting standards and lax cross-checking across different agencies lead to abundant abuses of these regimes (Benjamin and Mbaye 2012). In particular, large informal firms with high revenues find ways to pay minimal taxes under the lower presumptive tax regime.

The informal economy is excluded from public services that benefit the formal regime. Health insurance and pensions are particularly lacking. Certification of skills for workers is a problem, especially in construction (Benjamin and Mbaye 2017). Lagging certification of standards for services is also a barrier to modernization, particularly in the information technology sector. The informal sector has low barriers to entry and offers opportunities for those with little education and no capital. However, this open entry generates large numbers of firms operating at low productivity, with ownership or management structures that fail to incorporate modern systems of accounting and human resource management. Even the large and sophisticated informal firms, close in productivity to formal firms, still tend to operate like family firms in ways that keep them below the efficiency levels of their formal counterparts.

POLICY IMPLICATIONS

By examining the characteristics of the informal economy, we can identify weak links in the modernization process as well as points of entry where policy can help raise the returns to actors operating in the sector. As a reminder, the informal sector is the largest source of employment in African economies. The most direct approach to increasing the returns to factors is to raise the skills of informal workers by providing better basic education and vocational training (see, for example, Mano et al. 2012). Training in business management for SMEs has a decidedly mixed record, but in certain targeted sectors, as Mano et al. 2012 point out, it could help.

Policy regarding formalization should focus on large informal firms. These already have the capacity to function like formal firms, and a more rule-based regulatory enforcement could induce them to shift to formal firm status. It is difficult for any government to implement a viable development strategy when many major players are allowed to operate outside the system. Stricter rules should also apply to government officials involved in public or private businesses.

In between the large informal firms that could be formalized and the microenterprises that need basic assistance, there is a large segment of "semi-informal firms" that are not able to follow formal rules and still need public goods and services. Important aspects of these firms' performance (productivity, profitability, employment, and longevity) can be improved along the informality spectrum, rather than following a simple formal-informal dichotomy. While all these aspects of firm performance are important, the issues of productivity and employment have the greatest social impact. For these firms, policy should focus less on registration and taxes and more on what inhibits their modernization, such as access to public infrastructure services and business training, such as in finance, accounting, marketing and information technology.

When presented with the option of being formal or informal, these semi-informal firms have little reason to opt for formality. Yet surveys and interviews tell us that there are many intermediate bargains they would be willing to make. While firms want better governance and better public services, governments want better tax compliance (as do compliant tax-paying firms). A public-private bargain can enhance both public performance and private participation in the formal regulatory regime, including contributions to public finances. The dialogue on this mutual need for reform must include broad participation from the informal economy and not be confined to constituents focused on defending the status quo. Most informal firms would be willing to pay a little more in taxes if they could be guaranteed an increase in public services. Where trust in the public sector is low, government may need to make the first move. Some progress along these lines has been sponsored by organized unions of informal firms providing specific requests to government in West Africa, and more often in North Africa. In some countries, governments introduce service delivery guarantees where consumers get a refund if the quality of public services does not improve (Gelb et al. 2019).

Since most formal credit instruments do not match the high-risk nature of informal businesses in capital markets, most small and medium enterprises are much less likely to take up subsidized credit and, instead, look for more personal sources of financing. The high-risk character of informal business income and their lack of collateral need to be considered when finding ways to increase access to credit.

Finally, governments need to alter the structure of protected rents and wages. The relative incentives of productivity growth versus rent capture need to be rebalanced, as they have been in many East Asian countries such as Singapore, Malaysia, and Indonesia. Structural transformation in the current globalized economy requires a new view of how developing countries can provide a welcoming environment for modernizing forces while ensuring the welfare of its informal workers.

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Nancy Benjamin is a nonresident Research Fellow at the Development Policy Research at the University of Cape Town.

Ahmadou Aly Mbaye is a professor of economics at University Cheikh Anta Diop in Dakar, Senegal, and nonresident senior fellow with the Africa Growth Initiative at the Brookings Institution.

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