

The Informal Economy and Growth

Summary and policy-relevant findings



Street trader in Douala, Cameroon © www.commons.wikimedia.org

Recent iiG research and new data from Ghana show that carefully designed policies can increase the size of the formal economy. This would help to increase tax revenue and accelerate growth in Africa. Roughly half of the labour force in Africa is employed in the informal economy. Informal sector businesses and services do not pay taxes or comply with government regulation. As a result, governments are left with low levels of tax revenue. Workers in the informal economy have no access to pensions or health care. The main policy recommendations are:

- Registering businesses in the formal economy should be made easier and cheaper. It can take up to 73 days and cost USD 5500 to register a business. Set up costs should be reduced and spread over time. The time required to register a business should also be reduced.
- Improve access to credit. 70% of small businesses in Ghana say lack of access to credit constrains growth, but only 20% of large firms say the same.
- Make tax rates proportional to firm size to encourage growth of small firms into bigger firms. In Africa taxes for small firms are on average higher than the taxes charged to bigger firms. New evidence from Ghana shows that small firms are more likely to fail in their early years than large firms.
- Reduce inequality through wealth transfers and training programmes. In countries with high levels of inequality there are typically fewer firms in the formal sector. A high supply of workers means that salaries in the formal sector are low. Under these conditions people prefer to set up small businesses in the informal sector rather than earn the low salaries offered in the formal sector.

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Policy context

Roughly half of the labour force in Africa is employed in the informal economy. The informal economy provides jobs that would not have existed otherwise. However, there are also large costs through tax evasion, breaking the law, unfair competition, and exclusion from pensions and health coverage for workers.

Findings in more detail

What are the causes of the informal economy?

Gutiérrez-Romero (2010) shows that economies with a high level of inequality typically have few firms in the formal economy and a large supply of labour. Salaries in the formal sector are therefore low. Consequently, people prefer to set up small businesses in the informal economy.

Table (1) below highlights more reasons for the large informal sector in Africa. Launching a business in Sub Saharan Africa requires 11 steps which will take on average 73 days to complete. The cost can also be prohibitive: as high as USD 5,500 in Angola and USD 1,067 in Cameroon.

Table (1) Red Tape, Inequality and the Informal Economy

	Informal Economy (%GNI)	Gini	Number of Procedures	Duration (days)	Private Bureau Coverage (borrowers per 1000 capita)
East Asia & Pacific	24.3	41.7	8	66	107.0
Europe & Central Asia	37.7	32.5	10	48	30.6
Latin America & Caribbean	41.5	50.9	12	74	196.6
Middle East & North Africa	27.5	36.1	11	50	14.9
OECD: High income	16.8	31.1	6	30	443.5
South Asia	35.7	34.7	8	44	1.8
Sub-Saharan Africa	42.3	45.9	11	73	36.3

Source: Doing Business, World Bank (2004).

What is the impact of informality on growth in the long-run?

High levels of inequality, as is typically the case in Africa, are likely to lead to informality, a low rate of job creation and low growth. Gutiérrez-Romero's theoretical work suggests that very small informal entrepreneurs will eventually shut down. This is because their scale of production is not big enough for their profits to cover the cost

of replacing capital and labour costs.

Sandefur (2010) provides empirical evidence on the informal economy in Ghana from 1987 to 2003. Analysis of this unique data shows a massive entry of small firms. These small firms did not grow over time, but 'died young' limiting the prospects of long-run growth.

How can the economy formalise and grow?

Reducing red tape, improving tax-efficiency and tax-compliance and reducing inequality will impact on firm expansion. Both the theoretical and empirical work described here, also suggest that credit constraints constitute a significant drag on firm growth.

Ongoing and Future research

Cross-country comparisons within Africa are being done on the extent to which taxes, the business environment and inequality affect the formalisation of the economy and growth.

For more detailed information

Roxana Gutiérrez-Romero (2010) "The Dynamics of the Informal Economy". CSAE WPS/2010-07: <http://www.csae.ox.ac.uk/workingpapers/pdfs/2010-07text.pdf>

Justin Sandefur "On the evolution of the firm size distribution in an African Economy" CSAE WPS 2010/05:

<http://www.csae.ox.ac.uk/workingpapers/pdfs/2010-05text.pdf>

Information about Researchers

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