CHAPTER 6

The Failure of Structural Transformation in Francophone Africa and the Rise of the Informal Sector

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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 sub-Saharan Africa (SSA), the much-improved growth performance over the last two decades has not been accompanied by a corresponding gain in formal employment and poverty reduction. Figure 6.1 shows the average annual growth rates and cumulative reduction of the poverty rate over 1970–2014. While North Africa, East Asia, South Asia, and to a lesser extent Latin America had impressive declines in poverty, all regions of SSA had minimal or no poverty reduction, despite sizeable GDP growth rates.

This reflects the fact that in SSA, much of the counterpart of the declining share of output and employment in agriculture is the rise of the service sector, which is mostly in the informal sector. The informal sector has become the dominant employer in SSA and accounts for about half of the total value added in SSA. Furthermore, the low productivity observed in informal activities relative to formal activities suggests that the overall productivity factors would increase by shifting them to formal activities.

A further important feature of successful structural transformation is that growth results from reallocation of factors *between* sectors in addition to any growth within sectors. Figure 6.2 shows that in African countries, unlike in Asia, there is little growth attributable to 'between sector' reallocation over the period from 1990 to around 2015. For most countries in our sample, the 'within sector' component of productivity growth is higher than the 'between sector'. For resource rich countries like Nigeria and Mozambique, growth has been very high but without any structural

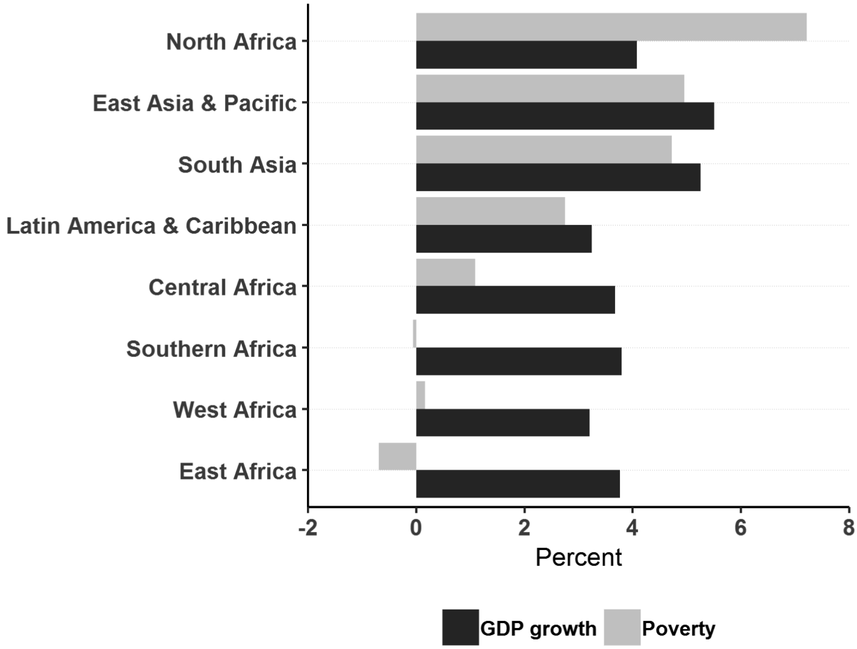

Figure 6.1
Annual GDP growth and cumulative poverty reduction in various regions, 1970–2014
Note: Percent changes are compound annual growth rate and unweighted regional averages
Source: Authors' calculation from Penn World Tables (Groningen Growth and Development Centre 2019a)

transformation. An extreme case of this general trend is Nigeria, where the structural transformation term is actually negative, as the economy's dependence on oil has increased. Even Botswana's impressive growth is entirely due to the 'within sector' component, reflecting the high reliance on the mining sector. For many resource-poor countries like Senegal and Malawi, growth has been much less impressive, as 'between sector' growth has been too low to compensate for low 'within sector' growth.

The distribution of productive factors matters for both structural transformation (between agriculture and the other sectors) and informality (between formal and informal business models). At the crux of the two distributions is the issue of productivity, and, thereby, the ways that transformation and informality affect economic growth.

The main messages include the following: relative returns to factors in the urban and rural sectors in Africa have given rise to substantial rural-urban migration, where employment opportunities for migrants and non-migrants alike are overwhelmingly in the informal economy. Thus, the informal sector is already the draw for transformational out-migration from agriculture. The main challenge is the modernization of

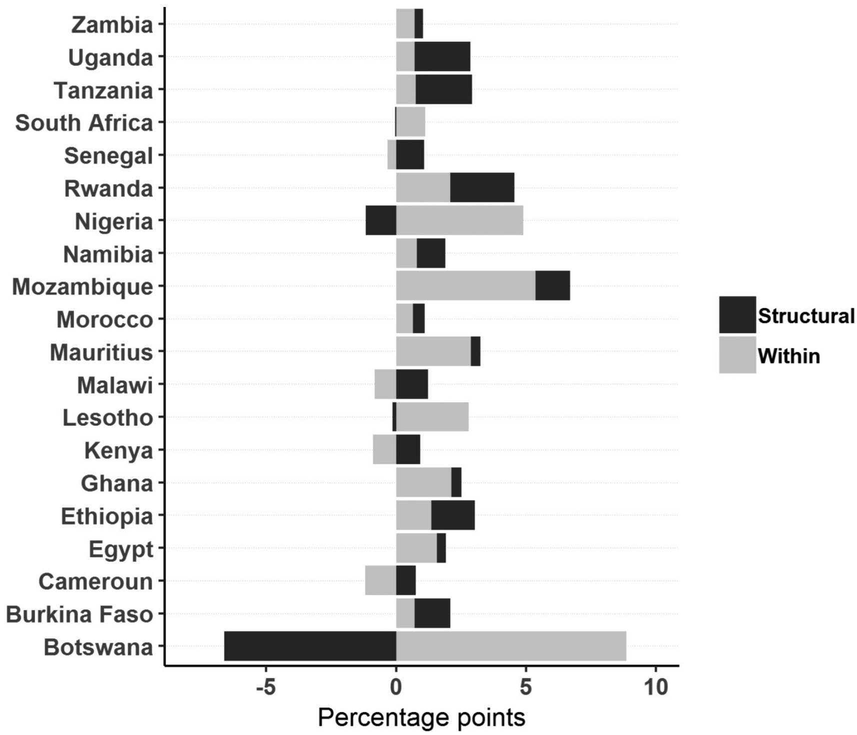

Figure 6.2
Decomposition of economic growth into structural change (between sectors) and within-sector growth, 1990–2010s
Source: Authors' calculation based on the GGDC database (Groningen Growth and Development Centre 2019b)

informal economic activity. The informal sector is quite diverse, with a strong majority of small subsistence firms, but also an influential layer of large, sophisticated, informal firms. These informal actors represent a large cadre of clients for business services and social services, but experience difficult relations with government and lack institutional support. Policy should focus on what constrains rapid modernization of the informal economy and thus inhibits access to the benefits of modernity, including higher productivity. Instead, policies often concentrate rents[1] into a small number of hands, raising factor costs for formal firms and in turn reducing the incentives for modern, international firms to provide an engine of modernization for the informal economy. Much of the data used in this chapter is drawn from the surveys described and presented in Chapters 2 and 4.

[1] The term "rents" refers to cases where people earn an income which is not commensurate with their level of effort nor the level of risk involved in the endeavour.

The remainder of this chapter is organized as follows: the first section reviews the dominant characteristics of the informal sector in Africa, the second describes some key aspects of the institutional environment in Francophone Africa and their implications for the informal sector and structural transformation, the chapter then addresses impediments to growth and formal employment, the following section analyzes the implications from the previous section's analysis for structural transformation, and the chapter concludes with recommendations.

The Informal Economy

As noted in earlier chapters, in SSA, the informal economy is highly diverse. Chapters 2 and 4 stress the importance of distinguishing large from small informal firms in describing behaviour and identifying obstacles in the investment climate. While the vast majority of informal firms are very small, large informal firms play a major role. A firm that chooses to be informal in a country with weak regulatory enforcement can become quite large and may have strong incentives to do so.

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, 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 can substitute for official institutions that should (but often fail to) support arms-length trading in the formal sector (Golub and Hansen-Lewis 2012).

As discussed in previous chapters, informal employment is overwhelming in West Africa. The informal economy employs most of the workers from vulnerable groups, including women and youth. By and large, the urban informal sector has open entry and provides employment for those leaving agriculture, which is the core migration underlying structural transformation. 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.

Rural-urban migration

Rural-urban migration is one of the most important determinants of the rise of the informal labour force in the developing world. Becker (2004) documents the magnitudes of such internal migration trends in developing countries and finds them to be astonishingly high in some instances.

For Africa, Kessides (2006) finds that the urban population has almost doubled in 15 years, mostly due to such migrations. As the classic Harris and Todaro (1970) model explains, migrants will flock to urban areas even if prospects of formal jobs are low, given that the wages in these jobs are so much higher than in rural areas. Most migrants end up in the urban informal sector rather than outright unemployment. Bhattacharya (2002) emphasizes, however, that the urban informal sector can be quite dynamic and is not simply a pool of surplus labour. As discussed in Chapter 4 and other literature, there are large disparities in access to basic services (education, health, and other infrastructural services) and earning opportunities between rural and urban areas that drive rural-urban migration in Africa. Fox and Gaal (2008) find that average earnings in informal services are higher than in agriculture by at least 50% in the majority of the African countries they studied.

Employment trends

Table 6.1 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: employment declines in agriculture, but it also declines in other tradable goods sectors, namely, industry, and a concomitant rise in non-tradables, 'Other services'. Given the steep requirements for becoming a global competitor in manufacturing, the performance in the other services sector will become increasingly important in Africa. This is also a sector where lack

Table 6.1
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 and 2015) and authors' calculations of quality control and regulatory oversight can be especially damaging to informal operators.

Using these employment figures to make rough estimates of labour productivity, it appears that the gap between formal and informal productivity is growing over time in most sectors.

Informal incomes

The lower productivity in the informal sector also translates into lower wages. Figure 6.3 shows very large earnings differentials between formal and informal workers, which are well documented across countries and geographical regions (Gasparini and Tornarolli 2007), particularly for Africa (Benjamin and Mbaye 2012). Chen et al. (2005) observe that economic growth has not resulted in improved standards of living in the informal sector. Braude (2005) found that education levels were much higher in the South African formal sector than the informal sector. These educational differentials undoubtedly contribute to differences in earnings between workers in the two sectors, albeit with substantial variation among informal workers.

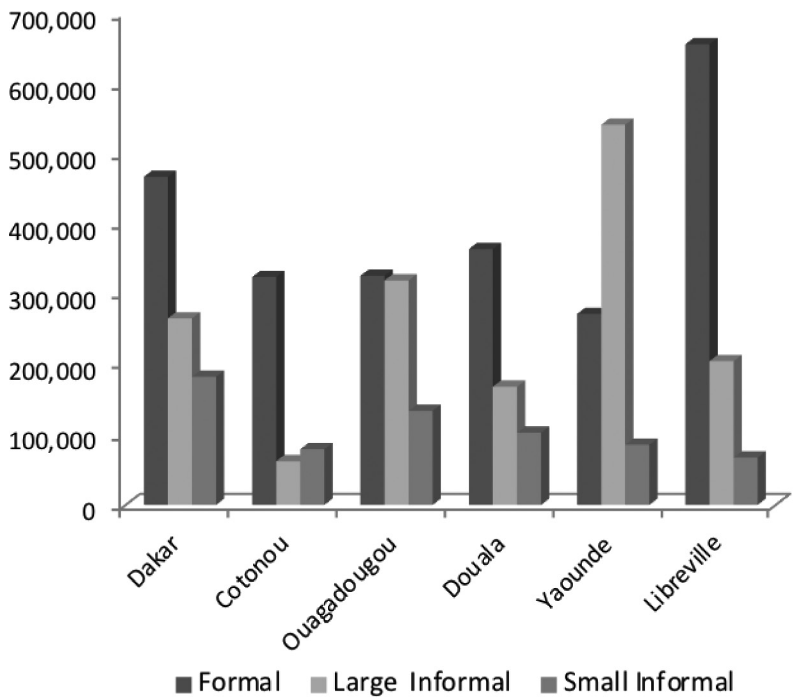

Figure 6.3
Average monthly wage by formal/informal status, FCFA
Source: Authors' surveys and calculations

High-paying public or formal sector jobs are protected, but also rationed. Figure 6.3 shows that Libreville in Gabon, an oil exporter with the highest per capita GDP among the countries represented, has the highest wages for employees of formal firms. However, the employees of small informal firms in Libreville are paid no more than the corresponding employees in five other Francophone African cities. The incomes of employees of small informal firms show the greatest degree of uniformity across the locations studied.

Productivity

Low productivity growth is a further manifestation of the rising role of the informal sector and the lack of structural transformation in Africa. Figure 6.4 shows Total Factor Productivity (TFP) growth has been minimal or even negative in SSA.

Part of the explanation for the low productivity growth in Africa is that informal firms usually have lower productivity than formal firms.

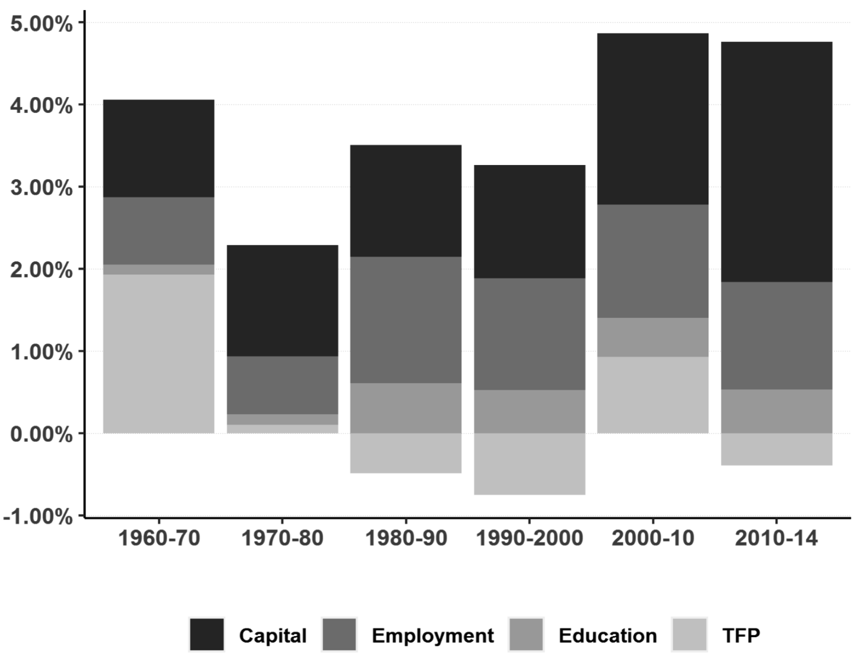

Figure 6.4
Growth decomposition for Africa by decade
Note: Data included for 13 countries until 1980 and for 28 countries through 2014
Source: Authors' calculation based on the Penn World Tables (Groningen Growth and Development Centre 2019a)

Thus, as the formal sector stagnates while the informal sector expands, economy-wide productivity growth is reduced. This is also the case in West Africa, as confirmed in Benjamin and Mbaye (2012) and in Chapter 9. Large informal firms, described in Chapter 2, have productivity levels that are usually between those of formal and small informal firms and sometimes even higher than that of formal firms. In general, the closer to formal a firm is, the higher productivity it tends to have. 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.

There is some empirical evidence to suggest that this wide range of productivity across firms can compound the difficulties of programs designed to raise productivity growth (Aghion et al. 2005). Some policies try to foster productivity growth by increasing competition. However, this approach may not be effective where there is a wide variance in firms' attributes and productivity.

Benjamin and Mbaye (2012) examine TFP in addition to labour productivity. TFP controls for capital intensity, yet they find the same positive correlation between TFP and formality as for labour productivity. This shows that differences in capital intensity alone cannot explain differences in labour productivity between formal and informal firms.

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.

The informal sector's modus operandi and organizational structure are not conducive to productivity growth. These features include weak management structures, lack of transparency, reliance on rents associated with political and social connections, and sub-optimal allocation of productive factors (including reliance on family sources for credit). Informality also inhibits modern management skills and worker training, limiting growth potential and access to the world market. The fact that these informal firms pay little tax and can avoid regulations gives them an unfair competitive advantage over formal firms, thus discouraging domestic and foreign investment, although relations between formal and informal firms can also be complementary, as discussed in Chapters 3 and 4. Furthermore, tax evasion by the informal sector in general, and large informal firms in particular, entails a substantial loss of fiscal revenues.

Institutional Environment

The crucial role of the institutional environment in fostering the informal sector is discussed in Chapters 3 and 4. Here we provide further evidence that the business environment remains quite hostile in Francophone African countries. Table 6.2 shows the time and costs involved in starting a business in Francophone Africa and in some more successful comparator countries. Costs remain very high in Francophone Africa and well above those of the comparator emerging economies by most measures. The number of steps required to start a business is not markedly different between the two groups, but the time involved and costs in Francophone Africa are much higher. Likewise, the number of taxes affecting businesses, and the tax rates on income, are high in almost all Francophone African countries. Labour market regulations are also perceived as onerous, as discussed in the following chapter. Furthermore, many of these nations face marked political instability and corruption.

Infrastructure

As seen in Chapter 4, firm managers have a dim view of the quality of infrastructure and public services. The countries under study rank poorly in the World Bank Investment Climate Assessment for the criteria of 'obtaining access to electricity' and in 'numbers of days of electrical

Table 6.2
Costs of starting a business and paying taxes in selected Francophone African countries and comparators, 2019

	Starting a business			*Paying taxes*		
Economy	*Procedures (number)*	*Time (days)*	*Costs (% of income per capita)*	*Payments (number per year)*	*Time (hours per year)*	*Total taxes (% gross profit)*
Benin	5	8	3.5	57	270	57.4
Burkina Faso	3	13	42.5	45	270	41.3
Cameroon	5	13	24.6	44	624	57.7
Gabon	7	31	6.1	50	632	47.1
Senegal	4	6	32.0	58	441	45.1
Botswana	9	48	0.6	34	120	25.1
Chile	7	6	5.7	7	296	34.0
Malaysia	9	13	11.6	8	188	39.2
Mauritius	4	5	0.9	8	152	22.1
Vietnam	8	17	5.9	10	498	37.8

Source: World Bank (2019) *Doing Business*

Table 6.3
Average electricity tariff in select countries, around 2015

Country	*Average Electricity Tariff in USD*	*Price as a Percentage of GDP per capita*
West/Central Africa		
Gabon	0.21	1.0
Cameroon	0.12	3.4
Senegal	0.23	9.8
Benin	0.22	10.5
Burkina Faso	0.23	14.7
East/Southern Africa		
South Africa	0.06	0.4
Botswana	0.08	0.5
Mauritius	0.19	0.8
Ethiopia	0.04	3.2
Tanzania	0.15	7.1
Rwanda	0.21	13.4
Developed Economies		
USA	0.12	0.1
France	0.19	0.2
Australia	0.29	0.2
Japan	0.26	0.3

Source: Blimpo and Cosgrove-Davies (2019)

outages per year'. Table 6.3 further illustrates the lack of competitive electrical infrastructure in the countries of interest. Electricity prices in West and Central Africa are among the highest on the continent. However, as a ratio of GDP per capita, these prices 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.

Financing

Even when commercial banks in West Africa are willing to lend to smaller firms, informal firms have a strong preference for other sources of financing, as shown by the low uptake on lines of credit offered by government and aid agencies. Chapter 4 reported an overwhelming reliance on personal savings, retained earnings, or loans from family members, even for formal firms.

Bank loans are expensive for all countries in West and Central Africa, as also seen in Chapter 4. Formal firms frequently pay 15% interest, while informal firms report paying 20% or more, despite very low inflation rates. Further, many firms report difficulty in repaying loans, particularly informal firms.

Labour

Formal wages are high relative to productivity in West Africa, particularly compared to the major exporters of East Asia. Golub et al. (2018) studied African competitiveness vis à vis China. In Table 6.4, overall productivity is proxied by GDP per capita, given the unavailability of employment data. Compared to per capita GDP, manufacturing wages are very high in SSA relative to a number of other countries. 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 SSA, however, wages are typically several times per capita GDP. The only exception is Mauritius and, to a lesser extent, South Africa. These high formal sector wages in Africa are far above informal sector wages, as previously noted.

High Factor Costs: Causes and Consequences

Predictably, 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 advantage is paying lower wages and lower taxes. Given the low international competitiveness revealed by the cross-country wage comparisons, export-oriented manufacturing production is almost non-existent. Formal firms are primarily foreign multinationals serving the domestic market that have no choice but to pay formal wages and formal taxes, but also benefit from import protection and other special advantages.

Mbaye, English, and Golub (2015) 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. The traditional saying is, "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, large informal operators may benefit from protected rights to exploit the unregulated segment. This can include informal rights to smuggling routes, protected rights to engage in untaxed retail commerce, or informal rights to supplement the rationed public transport (with vans or motorcycle taxis).

Table 6.4
Annual manufacturing wages, selected countries in Africa and other regions (current USD)

	2000		2010	
Country	*Level in USD*	*Relative to Per Capita GDP*	*Level in USD*	*Relative to Per Capita GDP*
sub-Saharan Africa				
Burundi	NA	NA	3,261	14.9
Cameroon	3,088	5.3	NA	NA
Ethiopia	771	6.3	807	2.4
Ghana	1,832	4.9	NA	NA
Kenya	2,118	5.2	2,854	3.6
Malawi	436	2.8	2,045	5.7
Mauritius	3,254	0.8	6,285	0.8
Senegal	3,680	7.8	6,450	6.5
South Africa	7,981	2.6	12,331	1.7
Tanzania	2,296	7.5	1,581	3.0
North Africa				
Egypt	2,028	1.3	3,453	1.2
Morocco	4,123	3.2	6,654	2.4
Tunisia	4,066	1.8	5,455	1.3
Latin America				
Brazil	5,822	1.6	10,918	1.0
Colombia	4,096	1.6	4,680	0.8
Mexico	8,048	1.2	7,310	0.8
Asia				
Bangladesh	NA	NA	680	1.6
China	1,016	1.1	4,770	1.1
India	1,356	3.0	2,619	1.8
Indonesia	929	1.2	1,897	0.6
Malaysia	4,405	1.1	6,548	0.7
Vietnam	NA	NA	1,727	1.3
Eastern Europe				
Czech Republic	3,964	0.7	12,673	0.7
Latvia	3,689	1.1	9,191	0.8
Poland	5,829	1.1	10,162	0.8

Source: Golub et al. (2018)

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, labour will tend to demand its share (Azam and Ris 2001). Thus, high formal manufacturing wages, in part, reflect overall protected rents in the sector.

This kind of rent distribution is not unusual in developing countries. When a certain share is allocated to a small number of elite firms and their workers, adding high wages to the other expenses of formal operations discourages the entry of new formal or modern enterprises, the sector stagnates. An interesting example can be found in the literature debunking the myth that the Dutch suffered from Dutch disease following the exploitation of natural gas fields in the 1960s and 70s. The subsequent stagnation of the traditional manufacturing sector in the Netherlands was found not to derive from a foreign exchange windfall, but rather from policies that raised social welfare benefits leading to higher wage taxes and an economy-wide increase in labour costs (Kojo 2015; Kremers 1986). While the Dutch policy may have instigated an economy-wide labour cost increase, in West Africa the high wages occur in the public sector and the formal private sector. Oil production in Central Africa has undoubtedly contributed to high public sector wages.

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 labour because the formal labour is not cheap. From the list in Table 6.4, only Mauritius, with manufacturing wages close to GDP per capita or overall productivity, has a strong record as a manufacturing exporter, and Ethiopia only recently so. The message is also a familiar one in West Africa: control of rents is more lucrative than raising productivity.

Given the strong advantage of paying the lower informal wage, it is understandable that formal firms hire people informally (off the books) in addition to their formally registered workers. Maintaining a formal veneer makes the company eligible for public contracts, cheaper credit, and more reliable infrastructure, while informal hiring provides access to workers at a lower wage and lower wage taxes. This occurs frequently in the construction sector where formal companies bid on projects, but informal workers provide much of the labour. Labour surveys in North Africa indicate that a majority of the people who report being informally employed are in fact working for formal companies (Gatti et al. 2014). Evidence from our surveys in Central and West Africa shows that formal firms pay a significant number of workers less than the minimum wage; in Cameroon, around 10% of formal sector workers earn less than the official minimum wage of 36,000 FCFA per month.

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 labour market regulations are necessary to attract foreign investment in export-oriented manufacturing and other traded goods and services. Thus, formal firms are concentrated in protected import-competing and non-tradable sectors, and exports of labour-intensive manufactured goods are non-existent.

Why Formal Firms are not Better Engines for Jobs in the Informal Economy

The abundant literature on foreign direct investment spillovers demonstrates that instances can certainly be found in which formal firms serve to improve the fortunes of informal enterprises. However, the relationships between formal and informal firms need to be examined in detail in order to understand the optimal conditions to make this happen, and how often this occurs. Chapters 3 and 4 demonstrate that relations between formal and informal firms can sometimes be fiercely competitive and sometimes cooperative in the form of outsourcing, but seldom of a nature that contributes to progress and development in the informal economy.

The sectors where we observe the most formal/informal competition over market share are those where government policy (i.e., a ban, regulation, tax, or subsidy) has created a kind of dual regulatory regime that is exploited by informal operators. In pharmaceuticals, formal quality standards allow room for informal products that may be cheaper, but lack quality control. Bans on the imports of used cars into Nigeria create opportunities for informal smuggling from Benin. Nigerian subsidies on gasoline lead to extensive smuggling into all neighbouring countries, including Benin. While all these activities create employment opportunities, the jobs are typical of informal commerce and do not appear to be a solid basis for development. And, where the business relies on publicly protected rents, formal/informal competition over these rents squelches any incentives for collaboration that would allow formal firms to contribute to modernization of the informal sector.

Narula and Pineli (2016) show that positive spillovers from multinational enterprises depend on the incentives they face. In West Africa, formal firms limit their subcontracting to informal firms largely to distribute their own products rather than produce for export. For example, multinationals hire local distributors to market imported fabric. Formal cement-makers hire informal companies to distribute their product and telecommunications companies hire locals to sell prepaid phone cards. Those who have these jobs prefer them over most alternatives available in informal commerce, but they are hardly the path to prosperity.

As discussed in Chapter 4, surveys in West Africa show that while large firms frequently sell products to small firms, a much smaller share (as low as 2% in Dakar) buy from small firms. Thus, by and large, foreign firms are not outsourcing production of their products to Africa; they are outsourcing marketing of their own products in Africa.

As also noted in Chapter 3, among the more modern services, the IT sector is an area with high potential outsourcing from major operators to smaller ones. However, our interviews revealed that such outsourcing is limited by the weak capacity of SMEs and corruption in both public and the private sector procurement.

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 the plateau in manufacturing employment occurs at about the same level of GDP per capita in today's developing countries as it did in developed economies. However, the leveling 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 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.

Henderson et al. (2018) have pointed out that developed countries that underwent structural transformation 100 to 200 years ago did so at a time when transportation costs were still high, and thus local demand gave rise to local production. At present, lower transport costs and globalized production have landed cheap consumer goods at everyone's door, limiting the need for local production. As Fox et al. (2013) and others have observed, current demographic trends indicate that the modern sector in Africa will not be able to absorb the migration out of agriculture for decades to come. Thus, informality plays an important role in present-day structural transformation, not only in absorbing the bulk of transitioning workers, but also in providing clues as to why modernization is not keeping pace and where policy can be most constructive.

Many of the pertinent issues come under the domain of governance and economic management. 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. In the capital markets, poor contract enforcement leads to high borrowing costs. Similarly, government 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 (described in Chapter 2). 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. Lagging certification of standards for services is also a barrier to modernization, particularly for the information technology sector.

The informal sector has low barriers to entry and 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. 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.

Recommendations

While the characteristics of the informal economy can help point out some weak links in the modernization process, it can also indicate points of entry where policy can help improve the level of earnings in the sector, the largest employer in the Francophone African economies. The most direct approach is to raise the skills of informal workers by providing better basic education and vocational training. Training in business management for SMEs has a decidedly mixed record, but, in certain targeted sectors, it could help.

Policy regarding formalization should focus on large informal firms (as also discussed in Chapter 8). 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 firms that are not able to follow formal rules and still need public goods and services. Important aspects of these firms' performance (i.e., 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 modernization and access to the benefits of modernity.

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. The specific services that small informal businesses seek most vary across locations and across sectors, so learning about the type of public service improvements that are most highly sought by informal firms and workers remains an important task.

Morocco, for example, has launched a public program that subsidizes social insurance for informal workers (Mbaye and Gueye 2014). While government ends up with the bill for social insurance, it encourages informal workers to formally register so at least the government knows about them.

In the capital markets, it is important to recognize that most formal credit instruments do not match the high-risk nature of informal businesses, hence the weak response to microcredit programs and the stronger preference 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. 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.

The informal economy has, and will continue to have, a substantial role in structural transformation in Africa. However, while it continues to absorb workers migrating out of low-productivity agriculture, it will also limit the potential for growth and productivity until modernizing forces exert more influence. The large or sophisticated firms can be expected to formalize as governments are more systematic in ensuring the benefits to those that do so. Formal wages may continue to decline toward per capita GDP, and this might make more African locations competitive for international grade manufacturers. Regardless, governments should focus on improving the regulatory environment for non-retail services, including IT, as these sectors can make important contributions to modernization. Experience in providing public services to the middle layer of informal businesses and their workers should improve their civic participation and generate efficiencies from extending the coverage of the regulatory framework. However, institutions that restrict allocations of rents will need to be checked to avoid counteracting modernization.

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