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Informal Economy and the World Bank

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Abstract

Many countries have expressed an interest in the size, performance and motivation of the informal sector, especially where the informal sector provides the livelihood and employment for a critical segment of the population. This essay reviews recent literature, methodologies, and relevant Bank studies as a way to share information with country teams interested in expanding their knowledge of the informal sector and related policy debates. Research in a number of regions points to four main areas where development policy can be improved by taking the informal sector into account. **First**, improvements should be made along a continuum; the heterogeneity among informal firms points to different policy approaches for different types of firms. **Second**, there should be public-private collaboration on mutual reforms. Many efforts to improve firm performance focus on elements of the production function (labor skills, credit) while treating government mainly as a cost (taxes, cost of compliance with regulations). Yet research reveals that many characteristics of the public regime strongly influence the decisions of firms regarding informality. **Third**, research indicates a strong relation between basic skills and labor outcomes, particularly in the informal sector, despite the sector's lower average returns. Research also indicates the benefits of targeted training programs. Business services programs have a decidedly mixed record, yet ongoing research is refining results on what works best. **Fourth**, informal trade is pervasive in developing countries and the networks developed in informal trade—wholesalers, credit suppliers and money-changers, transporters—are a strong presence in the informal sector. Yet these kinds of complex and nontransparent trading systems can be discouraging to foreign investors and can otherwise undermine trade policy and the international competitiveness of developing countries. The paper concludes with recommendations.

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Informal Economy and the World Bank

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I. Motivation for studying informal economic activity

Despite a sense of a growing informal sector in recent years, the extent of it and the main drivers are not necessarily well known. Many countries have expressed an interest in the size, performance and motivation of the informal sector, especially where the informal sector provides the livelihood and employment for a critical segment of the population. This essay reviews recent literature and relevant Bank studies as a way to share information with country teams interested in expanding their knowledge of the informal sector and related policy debates.

The existence of informal businesses is well-known, but the size, nature, sector and employment of their operations is not well-documented. Many Bank clients are seeking to close this information gap in order to better understand a sector that constitutes an important share of economic output and employment. Most studies usefully combine quantitative survey data with qualitative investigations of how the informal sector works, and both types of methods are discussed below. These existing studies indicate the importance of the following issues: governance, business climate, jobs, inclusion, and informal trade.

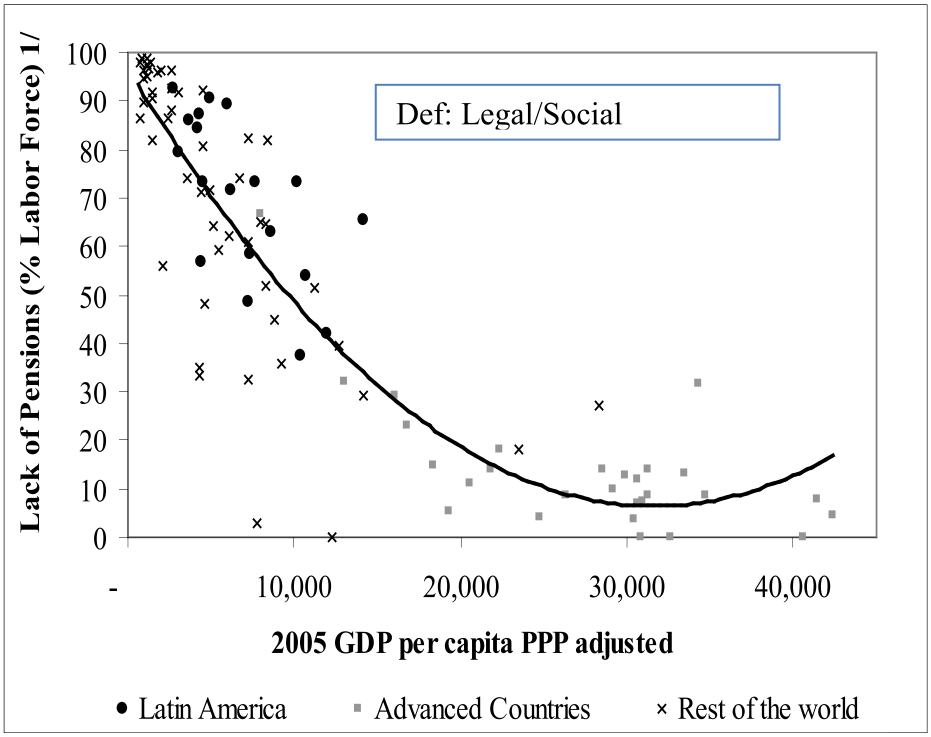
Research across regions has shown that governance of the regulatory and legal environment regarding commerce and business is critical to informality. The informal sector also reflects a pervasive sense of unequal opportunities; often workers and firm-owners in the informal sector feel they do not have the same options as those who are better-educated and better-placed to operate in the formal sector. At the same time, formal firms feel that informal firms pose unfair competition.

Finally, research in certain regions, West and North Africa in particular, shows that informal cross-border trade is pervasive, a major activity of the informal sector and provides a vital window on governance issues affecting the informal sector as a whole.

This paper collects information on World Bank studies of the informal economy in different regions, including the issues investigated and main findings. It also reviews methodology approaches in different studies as a way to inform future informal sector studies.

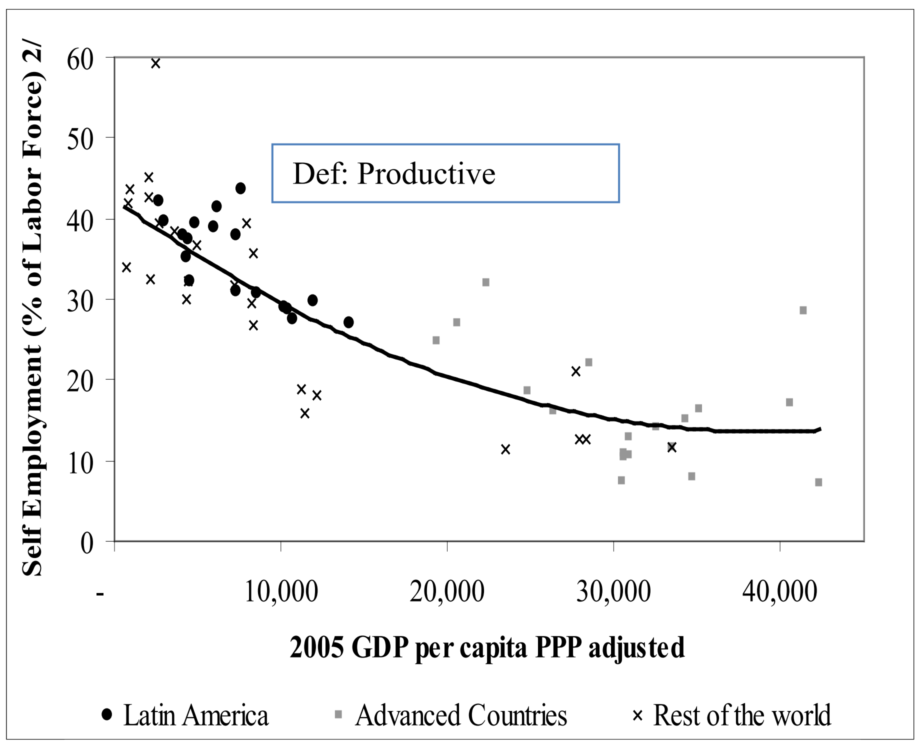
The informal sector varies across regions in its share of the total economy, but it has a significant role in the economic development of all World Bank Group client countries. Informality has been shown across regions to be associated with low productivity, and in one informative statistic, the informal sector is shown to have a lower share in high income countries, while counting for as much as 70 percent of low income economies in Africa.

Thus study of the informal sector presents a number of attractions, where its size suggests opportunities to create jobs, raise productivity, and promote growth and fiscal revenues, while the association of less informality with higher income suggests developmental advantages of reducing and formalizing the informal sector over time. At the same time, the sector poses a formidable knowledge gap since, by definition, some or all aspects of informal economic activity is off the formal record. Fortunately, much new work is currently ongoing that should help fill these gaps and aid in the development of policy recommendations.



Informality vs. income per capita

source: www.worldbank.org/wmaloney



A. Size and importance of the sector

Schneider and Enste (2003) estimate that the informal sector represents 10 to 20% of global output in developed countries and more than a third of global output of developing countries. The figures reported by the ILO (2002) are of the same magnitude: 48% of non-agricultural employment in North Africa, 51% in Latin America, 65% in Asia, and 72% in Sub-Saharan Africa. Focusing on Africa, Steel and Snodgrass (2008) report that the informal economy accounts for 50 to 80 percent of GDP and as much as 90 percent of new jobs.

Some of the largest and fastest growing sectors of African economies are dominated by informal firms: wholesale and retail trade, transportation, restaurants, reproduction of CDs and tapes, carpentry, construction, real estate, etc. This tendency for informal firms to dominate in certain sectors, notably retail, construction, and other services, also occurs in other developing countries (Adams 2008; Lund and Skinner 2004; Haan 2006). Verick (2006) also finds that the retail sector is the largest locus of informal activities in African economies.

B. Role in jobs and employment

Informal employment refers primarily to employment in enterprises that lack registration and social security coverage for their employees (OECD, 2009). It also refers to self-employment and precarious employment in formal enterprises. A distinctive feature of this type of employment is lack of social coverage and other related benefits applicable to formal employment. Hence it is highly precarious and vulnerable. Gaspirini and Tornarolli (2007) in their study of informality in Latin America identify the following characteristics to the informal labor workforce: mostly unskilled and operating in low productivity jobs, in marginal, small scale and often family-based activities. They add: "They are self-employed or salaried workers in small, precarious firms without a signed contract in compliance with labor regulations, and without access to protection against health and unemployment shocks, to savings for old age, to employment protection and to labor related benefits." These characteristics are also widely observed in Africa. According to ILO (2002), informal wage employment in Africa encompasses employees of informal enterprises as well as various types of informal wage workers who work for formal enterprises, households, or who have no fixed employer. These include casual day laborers, domestic workers, industrial outworkers, undeclared workers, and part-time or temporary workers without secure contracts, worker benefits, or social protection.

Most studies on the informal sector conclude that its workforce differs substantially from that of the formal sector. Self-employment is a predominant characteristic of the informal sector (Becker 2004). A study led in Botswana, Kenya, Malawi and Zimbabwe shows that about two-thirds of informal firms in these countries consist only of the owner (Haan 2006). The Botswana Central Statistics Office (CSO) (2008) study found that the majority of informal enterprises are either individually-operated or family owned. The same patterns emerge from Latin America (Maloney 2004). Gatti et al. (2011) find that 20 to 40 percent of workers in the Middle East are informal, working mostly for small firms.

Chen (2001) estimates that 93% of newly created jobs in Africa during the 1990s were part of the informal sector. Comparing the performances of the formal and informal sectors in terms of job creation, Xaba et al. (2002) find that employment in the formal sector is stagnant at best, or falling sharply, while in the informal sector it is experiencing dazzling growth.

Fox and Sohnesen (2013) in a study covering Burkina Faso, Cameroon, Republic of Congo, Ghana, Mozambique, Rwanda, Tanzania, and Uganda, estimate that wage and salary employment in private non-agricultural enterprises is still rare in SSA – this sector on average accounts for only 9 percent of the employed population.

C. Inclusion of disadvantaged groups

Fox and Sohnesen (2013) also find that the creation of informal household enterprises is the common resort for non-agricultural employment for those who lack education or who are geographically disadvantaged. Mbaye and Benjamin (2014) point out the role of the urban informal sector in absorbing rural migrants. Another characteristic of the informal sector is the strong female presence: 60% of working women in the developing world are in the informal sector. In Sub-Saharan Africa, 84% of employed women are in the informal sector. Likewise, Steel and Snodgrass (2008) also found that the majority (59 to 83%) of informal sector workers are women. This confirms the CSO of Botswana (2008) finding that in 2007, 67.6% of the country's informal firms were owned by women. According to Chen et al (2005), women are concentrated in the more precarious types of informal employment. Adams, de Silva, and Razmara, (2013) support this point on the basis of five African case studies.

Women often play an important role in ICBT (international cross-border trade) in Africa. MacGaffey (1991) points out that the subservient role of women in Congo pushed them into informal trading, including ICBT. In Zimbabwe, women constitute 85 percent of the traders (Ndela 2006) and in the Great Lakes Region, an estimated 85 percent of small-scale traders are women (Titeca and Kimanuka (2012)).

D. Role in productivity and growth

Most studies on informal firm productivity show that informality is associated with lower growth and productivity. Steel and Snodgrass (2008) find that the productivity differential between formal and informal firms is due mainly to unequal access to public services. Gelb et al. (2009) compare the productivity of formal firms and informal firms using surveys on the investment climate for a number of countries in southern and eastern Africa. Their results confirm that formal sector firms are on average more productive than informal ones but the gap between formal and informal firms is much less for east African countries than for southern African countries. They attribute this to the difference in the quality of the business environment and the enforcement of rules. The relative weakness of the state in East Africa undermines the performance of formal firms and provides little incentive for strong informal firms to formalize, thereby lowering the gap between formal and informal firm productivity.

La Porta and Shleifer (2008) obtain related results using World Bank informal sector surveys covering registered and unregistered firms in 13 countries and micro-enterprise surveys covering India and 13 African countries. Their most salient finding is that the productivity of formal firms is substantially greater than that of informal firms, although most strongly so in India. However, once they control for expenditure on inputs, human capital of the top manager and firm size, being unregistered has little additional impact on productivity. By contrast, Perry et al. (2007), find a residual negative impact of informality on productivity, even when other characteristics are controlled for. Using aggregated data, Perry et al. (2007) find that the connection between informality and low productivity has to be nuanced in Latin America. According to them, informal entrepreneurs are well aware of their limitations in terms of access to capital and skilled labor. Therefore, they tend to operate in sectors where it is possible to produce more efficiently on a small scale. Results from Benjamin and Mbaye (2012) corroborate the negative correlation between informality and productivity of if firms in West Africa. In addition, when informality is broken down into different degrees along a continuum, the level of formality and productivity are strongly and positively correlated. Mourji (2010) found a similar correlation in Morocco, while Backiny-Yetna (2013) found increasing degrees of formality to be correlated with higher tax payments in Niger.

As a corollary to the productivity differential, the relationship between informality and the agents' salaries has also been studied. Because of the productivity difference in favour of the formal sector, many studies conclude there is a higher salary level in the formal sector than for the informal sector. For example, Gatti et al (2011) estimate a formal sector wage premium of 10 to 50 percent in MNA, varying by country and age group of workers. However, average profits in the informal sector are in turn higher than in agriculture by at least 50% in the majority of countries (Fox and Gall, 2008).

II. Concept and definition

A central question in the study of the informal sector is its definition: what is informal and what is not? Most of the responses in the literature are working definitions, and refer to a spectrum of firm characteristics defining different degrees of informality. One issue facing researchers is that for several variables of interest -- the informal sector's weight in the national economy, its role in economic growth and productivity, the impact of the investment climate -- the estimations obtained from one study to another can vary greatly depending on the definition used (Mbaye and Benjamin, 2014). A second issue concerns the attempt to define criteria that are relevant to the realities of both developed and developing countries, which actually have strong differences.

A. Nature of non-agricultural informal activity

The most common criteria used to define the informal sector are size of the activity, registration with a government agency, and keeping regular accounts.

The size criteria

The size criteria mostly comes from the approach of the International Labor Organization (ILO), which defines an informal firm as an unregistered firm where the owner is an individual or a household whose capital is not separable from that of the firm and for which there is not reliable accounting that could permit retracing the operations of the firm (ILO, 2002). The ILO's approach, however, is not without problems (see Afristat 1997):

- It defines only the upper bound of informal activities' size at 10 and leaves countries the job of clarifying the actual size in national surveys on the informal sector. This allows a very large variety of choice by country in the threshold used.

- The inclusion or not of agriculture in informal sector activities is also left to the countries' discretion. The same is true of the inclusion of unpaid domestic workers, persons with secondary employment in the informal sector, rural areas, and whether a minimal age is taken into account.

All of this renders statistics on the informal sector so heterogeneous in the manner they were collected that comparisons among them at the international level are difficult.

Even when size is not used as a criterion of the informal sector definition, many studies note a very strong correlation between the size of an activity and its informality. For example, Dabla-Norris et al. (2008) find a strong positive correlation between the size of the business and its status as formal or informal. Benjamin and Mbaye (2012) found the same correlation between firm size and status, but they refute the idea that the size criteria can by itself be used as the single defining criteria of the informal sector. Based on survey data coming from three countries (Benin, Burkina Faso, and Senegal), they find a significant number of large firms that nonetheless remain in the informal sector in this part of Africa. They conclude that even when size is considered in the definition of informality, it must be combined with other criteria to have a good understanding of the phenomenon. Similarly, Gelb et al (2009) demonstrate from a database of 7 southern and eastern African countries that among the micro firms in their dataset, a large number are actually formal enterprises, and thus defining the informal sector based only on firm size is not applicable.

The registration criteria

Registration with a government agency is also often used as a defining criterion of the informal sector. Yet, the question of what type of governmental body is being considered remains here: is it the central or local government, the administration in charge of collecting taxes or another one? Gelb et al (2009) use registration with tax authorities as the criterion.

For La Porta and Shleifer (2008) the simple criterion of registration does not suffice to qualify a firm as formal. Among informal firms they distinguish between two categories: firms that hide by concealing themselves from the police, the fiscal administration, or other authorities, and firms that conceal a portion of their output even though they are registered. Thus they propose other criteria to define the informal sector and to measure its weight in the economy: the proportion of small firms and micro enterprises in the economy, the male participation rate in the work force, the proportion of workers who are self-employed in the non-agricultural economy, the proportion of workers who contribute to social security, the consumption of electrical energy, the mass of currency in circulation. The problem with these criteria is that they bear more relation to making comparison of national economies and give rise to fewer applications of firm-level survey data.

Focusing on Africa, Steel and Snodgrass (2008) refute the notion of the informal sector as an entity unknown to the fiscal authorities. According to them, informal activity is well-known and taxed by public powers that often allocate the stands that informal firms use for their business at the public market. Benjamin and Mbaye (2012) point out the presumptive tax that applies to the informal sector in Africa. They demonstrate from the tax database that even certain very small, informal firms without a known location are sometimes identified and listed by the tax department in Senegal. According to them, the registration and administrative recognition criteria are not easily applied, because even if informal firms are not always recorded at the level of central authorities, they are recorded at the local level where they also pay taxes.

The compliance-with-public-regulation criterion

This criterion is mostly developed by Kanbur (2009). According to him, state intervention is the central defining variable of informality. He simultaneously uses regulations and their enforcement to define informal activity. According to economic agents' attitude towards the introduced regulations, he identifies four different possibilities for economic agents' actions:

A) remain in the sphere of regulation and conform to it
B) remain in the sphere of regulation without conforming to it
C) adjust their activity with the intention of remaining in the sphere of regulation
D) remain outside the sphere of regulation

According to him, only category A represents the formal sector while B, C, and D, are informal. Thus the state's capacity to carry out the enacted rules determines a large degree of the economic agents' decision of whether to remain in the informal sector.

B. Informality as a continuum of characteristics

Whatever the criteria used, it is difficult to define the informal sector in a dichotomized manner (Benjamin and Mbaye, 2014). The criteria of size, registration, payment of taxes, etc. do not sufficiently discriminate between formal and informal sector firms. So, the informal sector phenomenon appears to be a continuum of situations defined by a set of factors that we combine to determine the place of each firm in the formality scale. Steel and Snodgrass (2008) note this as well: "There is a continuum of different degrees of formality in terms of different characteristics such as nature of registration, payment of taxes, management structure, contractual arrangements with employees, market orientation, etc." It is this continuous approach to the informal sector that is held by Mbaye and Benjamin, who establish six different levels of informality according to the number of criteria that a given firm has.

This is usually accomplished by defining a list of characteristics relevant to country conditions and analyzing from the survey data how many of these characteristics are true of each firm. Firms signaling similar numbers (though possibly varying lists) of characteristics can be usefully grouped together to indicate a degree of informality (Benjamin and Mbaye (2012), Mourji (2010)). While this type of definition may seem more complicated, in fact, in forming policy recommendations it can be useful to exploit the heterogeneity among informal firms. Perhaps the most informal need more business support services while the most sophisticated are the best targets for programs aimed at increasing registration or formal taxation.

C. Distinctions: Informal firms, informal activity, and informal employment

In the ILO's approach to informality, the distinction has been made between the informal sector and informal employment since the 17th International Conference of Labour Statisticians (ICLS) in 2003. The informal sector refers to all the firms described in section A above, notably by the criteria of size and business records, while informal employment includes the employees of the informal sector, unpaid family workers, workers with precarious status in formal firms, and unpaid domestic workers.

It is also useful to distinguish between informal firms and informal economic activity, since workers can be employed informally or 'off the books' by formal firms. As noted above, La Porta and Shleifer (2008) distinguish between informal firms that fail to register with authorities, and those that are registered but understate revenues. Gatti et al. (2011) note that in the Middle East/North Africa, approximately one-fifth of the sales and workers of registered firms are not reported.

The Organisation for Economic Co-Operation and Development (OECD) similarly makes the distinction between the informal economy and the hidden economy, where the latter concerns firms that hide a proportion of their production and that could be either formal or informal.

III. Approaches to measuring informality

While a few data bases are readily available for many countries -- Informal ICA Surveys, World Bank Enterprise Surveys[1], household socio-economic surveys, the Schneider Index – the following sections are intended to serve those who would like to conduct surveys of firms among a sample of firms that more closely represents the significant categories of informal firms active in a specific country.

A. Surveys of firms: Pros and cons

Surveys of firms can capture both firm-level information and worker-level information -- both employers and employees. As indicated above the most readily available firm surveys include:

- Informal ICA Surveys: ICA surveys include a category labeled Informal; however these are largely based on official lists of firms, where informal firms are designated according to size (usually firms with fewer than five employees). While these surveys may include many informal firms, or even be comprised of a majority of informal firms, they mainly rely on a sample frame of formally listed firms and do not include household enterprises [Nigeria, 2009 is an exception].

- World Bank Enterprise Surveys: These surveys are recently including more data from firms sampled in well-recognized informal market places. Even so, while the firms surveyed there are quite probably informal, there remain issues of representativeness of the overall informal sector. Informal marketplaces can cluster businesses by type for a variety of reasons, including by sector or relations among proprietors, for example. And this approach also leaves out enterprises conducted in dwellings, or with no fixed location.

Thus the main limitations of firm surveys concern sample frame issues. Enterprise registries may miss some formal firms if not updated (and by design may miss all informal firms – predominantly micro enterprises). Attempts to expand the sample frame may not be representative as firms may be clustered in location or "hiding" in dwellings.

Overcoming these limitations requires developing a sample frame of firms that includes many that are not on any official list – national or local, registration or tax – or are not known to national-level authorities. A similar issue was faced in the design of Rural Investment Climate surveys[2]. However, with a focus on the rural economy it is feasible to use a geographic approach, e.g., survey all buildings in a sample of communities for the existence of businesses or households running businesses. This approach is difficult to apply in an urban setting. Therefore, urban informal sector surveys generally make use of household surveys for identifying small informal enterprises, household enterprises, and informal self-employment.

[1] While ICA surveys cover opinions on the investment climate and Enterprise Surveys cover firm performance and employment, there are varying degrees of overlap between the two surveys, depending on the country.

[2] Highly relevant background information can be found in a useful manual -- Methodological Guidelines: Rural Investment Climate Survey, July 2010, linked to 'Agriculture and Rural Development > Rural Investment Climate'.

B. Surveys of households: Pros and cons

Like firm surveys, surveys of households can also capture information both about workers (whether they are employees or are working in a household enterprise) and firms (as reported by workers, or as pertaining to the household enterprise). Examples include LFSs and LSMSs.

Such household surveys can be conducted in two phases, or as combined household/enterprise surveys. The LSMS, for example, pursues information on employment and household enterprises in a single phase. Such surveys have a labor module (asking each member about labor and for employees, sometimes traits of the firm/employer) and a household enterprise module (asking for firm level details about every household enterprise [HHE] activity). And the two sections should cross-check. (If someone is self-employed in the labor module, there should be at least one enterprise in the HHE module; and vice versa). In the DIAL (Développement, Institutions et Mondialisation) 1-2-3 surveys, the first questionnaire (1) identifies households with informal firms and the second questionnaire (2) collects details about those businesses. In some cases, the second questionnaire is implemented later (requiring a revisit to the survey area) but in other cases it is collected during the same phase of field work.

Among the limitations of household surveys is the fact that employees are unlikely to reliably report firm details. Something like firm size threshold (say <5 or >4) is likely to be reported reliably. However, they may not provide satisfying information on firm decisions and firm behavior. It is possible to use household surveys to indicate the distribution of small informal firms, and then interview separately a set of firm managers according to this distribution, in order to get better firm data. (See Ethiopia RICA) There are some examples of employee-employer matched survey efforts, but not many from developing countries.

Another important limitation of household surveys is that it unlikely that these surveys can offer sufficient coverage of large firms (through a sample of their workers) when these enterprises are concentrated in a country (in a specific city or location).

An important lesson from existing studies in many regions is the strong heterogeneity across informal firms. Yet this heterogeneity may be usefully exploited in drawing analytical conclusions or in developing policy – suggesting different policies for different segments of the sector. Such heterogeneity among informal firms also implies the need to stratify survey samples for particular groups of firms. These groups can usually be identified according to country knowledge and specific issues. New work may benefit from the experience of earlier studies on this point. It points to the fact that without booster samples and stratification, the existing national household surveys regularly produced in the statistical systems (such as LSMSs, HBSs, LFSs) may not have appropriate samples to offer in-depth analysis of the informal sector. But, nonetheless, they may offer a first cut glance at the extent of informality in a country.

While HH surveys are essential for building a sample frame of informal household and micro-enterprises, the stratification strategy referred to above will inevitably point to a class of firms that are fundamentally informal in significant aspects of their behavior, and yet are listed on official business, tax or customs registries. For sampling these firms, access to official business and tax registries is essential – even if no firms are identifiable by name (though activity sector and size are critical). Finally, it is highly useful to develop a list of control firms – formal firms that otherwise have characteristics similar to at least some of the informal firms in order to provide comparator statistics on important variables, such as productivity. If informality is defined as a continuum of characteristics, a control group of formal firms is even more important.

These approaches, of course, may vary by type or income level of the country and estimated share of the informal economy. As a single example, Benjamin and Mbaye (2012) working in West Africa drew samples from official firm registries and tax rolls, and from micro and small informal enterprises identified in 1-2-3 household surveys, while stratifying for large informal firms, which were known to be influential.

Beyond surveys, other resources include the Schneider Index: This country-level index draws on primary data sources listed above. It estimates the share of an economy's total production that is not declared to tax and regulatory authorities. This apparently combines the activities of informal firms and informal activity conducted by formal firms. So while providing a quick estimate of the informal share of the economy, it does not provide information on sectors, firms, employment or firm behavior.

IV. Qualitative data and the policy agenda

Many firm surveys ask respondents to choose the greatest constraints they face in business from a proposed list of constraints, or to assign priorities to a proposed list of issues. This provides a way of quantifying data on opinions. Still, the responses do not tell us how a given issue is a constraint, how it affects business, or how they might respond if policies were changed. Interviews and other forms of qualitative data can help uncover the story that provides clues on these points, which are of great importance for policy development.

A. Interviews with major players

The most important and basic information to collect about the informal sector is to learn how this important segment of the economy works. Surveys based on an extensive sample frame as described above can provide data that will allow comparison of different types of informal and formal firms regarding productivity, competitiveness, technology, skills, jobs and income, inclusion of disadvantaged groups, credit, trade, and priority issues.

However, studies of the informal sector have benefitted much from combining quantitative and qualitative data. For example, even surveys of informal firms that offer 'pick lists' of constraints do not provide the full story of what needs to be changed in order to promote better performance of informal firms, better survival of firms and better job creation. What is critical is to gain an understanding of how firm managers perceive the institutional context and how the system works. Qualitative interviews with major players and government officials can help characterize the informal economic system identify critical issues and how participants perceive the regulatory environment. Major players can include directors of important firms, both formal and informal; representatives of labor groups; leaders of organizations representing informal businesses; leaders of ethnic or family business networks; and other civil society groups. Government officials should include tax and customs officials as a minimum.

B. Focus groups

Focus groups have increasingly been used as a complementary tool to gather information and discuss issues that individual respondents may not feel comfortable to discuss in a more formal interview setting. This approach has been used extensively by market research specialists, sociologists and economist for a variety of purposes at different stage of the policy making process: (i) to help better define the questions (or problem) at hand; (ii) to validate findings of an initial assessment; and (iii) to identify possible policy recommendations. Focus groups have also often been integrated in the data collection and analysis process as a means to reduce possible errors and biases.

The advantage of using and integrating focus groups in data collection and analysis goes beyond the methodological benefits. Focus groups used while tackling sensitive policy issues (like for example corruption) have proven instrumental for the creation of greater consensus and ownership of the reform process. This broader ownership has in turn facilitated the implementation of the reforms and has also helped support the reform efforts in the medium term.

However for focus groups to be effective, these need to be properly defined and open to a broad range of stakeholders. Closed or narrowly defined focus groups do not facilitate the flow of information and dialogue necessary to create consensus and to promote ownership.

The implementation of focus group to information gathering and policy development requires careful design and planning.[3] This investigative tool is not simply a workshop where diverse stakeholders can share experiences and views. Focus groups are more than a group interview. They are rather a "collective conversation" and should value and emphasize group interaction. Focus groups are as sophisticated a method to gather information as surveys can be.

The primary aim of a focus group is to describe and understand the views and experiences of a selected group of people to gain a deeper understanding of a specific issue from the perspective of the participants of the group. Focus groups do not aim to reach consensus as they encourage instead

- Key elements for a successful focus group discussion are: Clear definition of the issue(s) to investigate
- Identification of key stakeholders and definition of sample of potential participants
- Specification of facilitator's role and training
- Definition of the questions to be discussed for each session of the focus group discussion
- Definition of the outcomes to be achieved for each session of the focus group discussion
- Development of script for focus group implementation
- Definition of the focus group rules
- Piloting of script and questions, and revisions if necessary

This approach has been used successfully in various contexts by the World Bank, such as for example, the identification of priority areas at the country level for governance reforms (http://go.worldbank.org/QFWZEIB1C0); the policy discussion on crime and violence in Latin America and on health issues in Africa.

[3] Please see P. Liamputtong (2011) and D. Morgan (2002) for an excellent overview of this methodology

V. Issues in current research

The informal sector is more than just 'the other part of the economy' to which all traditional analysis equally applies. The sections below describe recent research exploring issues specific to informality.

A. Informal employment

1. MNA

[This section is based on Gatti et al. 2011).] According to the Schneider index, informality has been increasing in the MENA region. It is highest among the working poor, and while informality generally decreases with wealth, it can even be found among wealthier segments of the population. Also, lower education is strongly associated with higher rates of informality, an association that seems driven by the dominant role of the public sector in hiring more educated workers.

Informal employment is highest among youth, a significant phase before an adulthood transition into public sector employment. For example, informality rates are very high for youth between the ages of 15 and 24 after which, informality decreases rapidly. These trends differ from Latin America, where a similar decrease in informality by age is associated with increases in other private sector employment or self-employment, in contrast to the dominance of the public sector in the Middle East.

Informal workers are concentrated in small firms with less than five workers, who are likely to be engaged in low productivity activities. Micro and small firms, which account for a large share of enterprises and private sector jobs in the region, are mostly unregistered and employ workers informally. And even among registered firms, approximately one-fifth of their sales and workers are not reported.[4] Informal workers earn lower salaries than formal workers with similar skills, with an estimated wage premium for formal jobs varying from 10 to 50 percent across the region. Most measures of job quality suggest poorer working conditions in informal jobs. Mobility from informal to formal jobs was found to be extremely limited. For example, between 2008 and 2009, an informal worker in Egypt had a 4 percent chance of moving to a private sector formal job and a 5 percent chance of moving to a public sector job.

Given the low mobility for workers, recommendations based on the MENA work highlight the importance of fostering more private sector competition, as well as reforming the civil service where generous benefits induce queuing among workers. Recommendations also include convening a broader segment of civil society to reform labor regulations in order to avoid replicating the status quo by those whom it favors. Finally, it recommends targeting some well-designed skills upgrading interventions, especially in the poorer countries and in rural areas where Informality's low productivity dimension is especially pronounced.

[4] According to Silva et al (2009) up to 55 percent of informal workers are employed by formal firms in Morocco where informal workers constitute the majority at firms with either business or tax registrations.

2. South Asia

More and Better Jobs in South Asia (World Bank, 2012), based on a survey of 26,000 firms, does not explicitly study the informal sector, but acknowledges that the vast majority of jobs are in the informal sector, as will be the vast majority of new job creation. It confirms for South Asia results observed elsewhere in the informal sector, namely that access to credit is a relatively lower priority than is access to infrastructure and dealing with the corruption infesting relations with public utilities and tax services. It also favors an education and skills agenda with a view to protecting workers rather than protecting jobs through regulations, given that formal private sector wage jobs are available to very few.

3. Rural-urban migration and informal employment

Rural – urban migration is one of the most important determinants of the rise of informal labor force in the developing world. Becker (2007) documents the magnitudes of such internal migration trends in developing countries and finds them to be astonishingly high in some instances. For Africa, Kessides (2005) finds that urban population growth has almost doubled in 15 years, mostly due to such migrations. 'Despite the existence of positive marginal products in agriculture and significant levels of urban unemployment, rural-urban labor migration not only continues to exist, but indeed, appears to be accelerating.' (Harris and Todaro, 1970)

In the classic Harris and Todaro (1970) model, the informal sector is the main refuge for the urban unemployed and the host of the newly arriving rural migrants on their way to the formal sector jobs. Using an improved version of the same model, Bhattacharya (2002) emphasizes: 'the Informal sector is not primarily a transit camp for disappointed migrants queuing for formal sector jobs, but a dynamic sector making substantial contributions to income and output, capable of attracting and sustaining labor in its own rights'.

Urbanization and informality have been studied in India (Urbanization and Informalization by Ejaz Ghani and Ravi Kanbur, World Bank, 2013) and in South Africa, Cornwell and Inder (2004), Asfaha, and Jooste, (2006), de Haan, Kirsten, and Rwelamira (2003)[5], but is largely understudied elsewhere.

B. Informal trade

Like much informal economic activity, informal trade is not easy to define with precision, since practices differ from one border to the other. In general, informal trade is defined as the international flow of goods that are unreported or incorrectly reported by the country's customs authorities. This includes trade in goods passing through border posts with false customs declarations as well as goods that cross the border without the knowledge of customs authorities, either through border posts or elsewhere along the border. (Ayadi et al, 2013)

And while foreign trade always involves movements of goods and services across international borders, informal cross-border trade (ICBT) is more narrowly defined as the flow of goods and services across the international land borders between neighboring countries. Its unique feature is that very close geographical proximity renders transportation cost immaterial allowing those who are able to cross borders regularly to take advantage of differences in the supply, demand and price of various goods and services available on either side of the border.

[5] See also : "Youth Employment in Sub-Saharan Africa," D. Filmer and L. Fox, editors, World Bank, 2014.

1. West Africa

While formal intra-African trade accounts for only about 10 percent of total African exports and imports, casual observation indicates that informal cross-border trade (ICBT) is thriving almost everywhere in Africa. And while most informal trade is illegal in the narrow sense of going unreported and untaxed, the products involved are mostly otherwise legal. ICBT can take a number of forms:

"A particularly significant component of unofficial trade in Africa involves "re-exports" whereby goods are imported formally into a low-tax or low-cost country with the intent of then transshipping them clandestinely into neighboring countries with higher taxes, restrictive import quotas, costly trade facilitation services or tougher regulatory standards." (Golub, 2014) Similarly, trade in local primary products across borders to balance local shortages and stabilize prices has a long tradition.

Since informal trade is unrecorded, various sources are brought together to generate estimates of these flows. The methodology generally includes examining official trade statistics for signs of unofficial cross-border trade, hiring national consultants to conduct brief and confidential surveys of traders at the borders, observing transactions at key border crossings, and interviewing customs officials and private sector representatives about these transactions.

An example of using official trade statistics, "Mirror" trade data compare recorded imports of a country to recorded exports from partner countries. If the reported exports exceed recorded imports by more than apparent trade costs, the remainder is probably informal trade. This approach was used in *Cross-border Trade within the Central Asia Regional Economic Cooperation,* World Bank (2009). However, mirror data does not fully capture Intra-African informal trade, since the trade flows go unrecorded in both the importing and exporting countries.

Nevertheless, Raballand and Mjekiqi (2010) and Golub (2012) use mirror trade data to show that Benin imports an unusually large amount of certain products, in excess of what can be explained by domestic consumption and production, and infer that the residual is re-exported unofficially. Benjamin, Golub and Mbaye (2014) similarly look at imports per capita of particular consumer goods in Benin and The Gambia and find them inexplicably high for commodities with high protection rates in neighboring countries. Further, national customs offices often collect information on whether imports are "for domestic use", "re-exports" or "transit", although extracting this information from them may take some effort.

Observation at borders is best supplemented by surveys, so that the observed volume of flows can be complemented by survey questions about content. Even so, transport routes taken by ICBT are varied, and while some traders cross at official border posts, with partial or full cooperation of customs officials, others avoid customs checkpoints.

Interviews with major players in the business of informal trade can help illuminate the modalities of the trade – the financing, transport, re-packaging, arrangements with wholesalers and retailers. ICBT in Africa is closely connected to domestic wholesale-retail trade, where the informal sector dominates. Further, ethnic, religious and kinship networks play a large role in organizing the informal sector, and are particularly important in ICBT given that their populations often straddle national borders (World Bank, 2013; Golub and Hansen Lewis, 2012).

The volume of ICBT is often estimated to be many multiples of official cross-border trade. For example, World Bank (2013) found that bilateral Cameroon-Nigeria trade of domestically-produced goods was $230 million, compared to officially-recorded flows of $10-$40 million. Including re-exports, ICBT rises to about $1 billion. Similarly, ICBT in West Africa and the Horn of Africa vastly exceeds reported bilateral trade. (Golub, 2014, Little 2005, 2010)

In addition to longstanding practice of trade along traditional routes, ICBT is strongly influenced by large price differences across borders. These are usually caused by cross-border differences in trade policy measures, such as tariffs, subsidies, and product-bans. The trade prompted by these price differences is facilitated by government's limited capacity for monitoring or enforcement of regulations along porous borders, along with widespread corruption. And while cooperation between customs and tax authorities would facilitate enforcement, such cooperation is often resisted by the respective agencies.

ICBT has been found to be a highly significant component of the local economies of border communities. This is particularly the case in certain poor communities in the Sahel and border regions of the Maghreb (discussed below). The lack of alternative livelihood in these poor border communities, and the relation between them and the formal customs service, need to be taken into account in any development of policy recommendations.

2. Maghreb

Informal trade is known to be pervasive in the Maghreb. While trade policies in the region are fairly similar, domestic subsidy policies differ substantially across countries, especially between oil exporters and importers, leading to strong cross-border price differences. This section is drawn from a study of cross-border trade between Tunisia and its neighbors: Estimating Informal Trade across Tunisia's Land Borders (Ayadi et al., 2013).

Although informal trade accounts for only a small proportion of Tunisia's total trade, it plays a significant role in bilateral trade with Libya and Algeria, and in certain sectors. It accounts for more than half the country's trade with Libya, and an estimated 20% of the fuel[6] consumed in Tunisia is from informal imports from Algeria. The main reasons behind this large-scale informal trade are differences in the levels of subsidies on either side of the border as well as the varying tax regimes.[7] For example, the price of fuel is around one-tenth in Algeria of that in Tunisia.

The growth in this type of trade has a significant impact on several aspects of the Tunisian economy. Fuel is cheaper, but government revenues are reduced, not only because goods are not subject to customs duties at the Tunisian border, but also because traders avoid paying value-added tax (VAT) provided they remain within the informal network. This loss of revenue can be significant.

Moreover, this type of trade has an important economic and social impact in border regions. In many of these regions, informal trade is one of the most important economic activities—if not *the* most important—as is the case, for example, in Ben Gardane. Numerous individuals and organizations are

[6] This is based on data from STIR showing fuel imports of 2,790 million tons as against national fuel consumption of 3,746 million tons (source: www.stir.com.tn). We used an estimated weight of 0.792 tons per cubic meter of fuel (source: www.unitjuggler.com).

[7] This confirms findings of ICG (2013).

involved in informal trade. While some are highly visible, such as transporters carrying the goods across the border, street vendors, and ad hoc traders, others are less so, such as wholesalers, currency changers, and officials in the relevant administrations who are willing to turn a blind eye to the practice. Interviews underlined the pivotal role played by wholesalers, who control the supply chain and distribution network and are best informed about possible commercial opportunities that may arise as a result of changes in customs duties or tax rates. This kind of trade also keeps many goods within budget for Tunisian consumers.

C. Investment climate: What encourages informal firms to formalize?

Over the past few years, a large part of the literature on the impact of improved business regulations has focuses on the links between easing business entry and increased entrepreneurship. A common finding is that substantial improvements in the ease of start-up are linked with more firms registering: making business registration and operations simple, cheap and fast can encourage formalization.[8] However, this assumption cannot be entirely verified.

An early literature review on business entry reforms found that the introduction of significant business entry reforms is directly associated with an increase in the number of firms, and that a significant reduction in business registration costs affects new firm creation more in industries with low barriers to entry than in those with high barriers.[9] Smaller reforms – such as Lima's (Peru) simplification of just the process to obtain a license to start a business – seem to have had no significant effect on firm performance.[10] Interestingly, the existing literature on the effect of entry regulation on formalization, and the effect of formalization on performance, focuses on studies conducted in Latin America and Southeast Asia.

In Mexico, Bruhn (2011) analyzed the impact of a reform that, in 2002, reduced the number of days taken to start a business from 30.1 to 1.4. The reform was implemented sequentially in different counties in Mexico, and allowed for a quasi-natural experiment using data on individuals' employment status from the Mexican Labor Market Survey (ENE). The analysis found that the reform increased the number of registered firms by 5 percent.[11] Branstetter and Taylor (2010) found that, in Portugal, the introduction of a one-stop shop, which decreased the number of days to register a business by 91%, led to an increase of new firms created by over 17%.[12] However, recent studies have found that information campaigns following simplification of registration requirements result in very few informal firms registering.[13]

In addition to easier business entry procedures, informal business could in principle benefit from a more secured and predictable taxation system, in particular for SMEs, which would minimize the risk of risks of harassment from tax inspectors.[14] To date, there is no empirical evidence of the effect of tax protection that would directly benefit micro or small businesses.

[8] Klapper, Leora and Inessa Love, 2010.
[9] Motta, Marialisa, Ana Maria Oviedo, and Massimiliano Santini, 2010.
[10] Lorena Alcázar, Miguel Jaramillo, Mimeo, Grade, June 2011.
[11] Bruhn, M., 2011.
[12] Branstetter, Lima, Taylor, Venancio, October 2010.
[13] See Andrade, G. H., Bruhn, M., McKenzie, D. (2013.
[14] See, for example, De Mel, S., McKenzie, D., Woodruff , C., 2013.

Another set of studies analyzes what happens once firms formalize. One of the outcomes of interest studied by recent studies is whether formal firms show increased performance with respect to informal firms. Recent rigorous experiments in Sri Lanka and Brazil have explored whether formal firms do receive more bank credit, but they have found no evidence of this: the extent of bank financing extended to formal firms, after they formalize, does not increase. Other studies have inquired whether it is access to credit, as opposed to additional credit, that would increase as a consequence from formalization. McKenzie and Woodruff (2008), using evidence from Mexico, show that relieving credit constraints leads to increased returns to capital of 20-30%, on average, and 70-79% among those firms that reported being financially constrained.[15] By facilitating hands-on access to the banking system, formalization seems to be increasingly attractive and beneficial to firms.

Formalization seems to be connected with higher performance. Fajnzylber et al. (2011) analyzed the impact of Brazil's formalization program, SIMPLES. They found that formality increases firm employment by 40-50% and increases the probability of having a fixed location by a 30-50%, leading to large increases in revenues and profits.[16] Analogously, in Viet Nam, Rand and Torm (2012) find that firms that decided to formalize in the period 2007-2009 saw an increase in their profits and investments compared to similar firms that remained informal.[17] McKenzie and Sakho (2010) found evidence in Bolivia that firms that become formal issue more tax receipts and have greater sales. [18] De Mel et al. (2013) find that firms in Sri Lanka are more likely to advertise. Finally, in a recent literature review, Bruhn and McKenzie (2013) show that formalizing may help firms to expand their customer base.[19]

D. Investment climate: What helps informal economic actors?

Recommended policies for the development of the informal sector depend greatly on the nature of informal firms as well as the causes and effects of informality. For example, various programs have been proposed to help informal firms, especially the smallest micro and household firms, overcome their weak access to social services. Others, noting the importance of the overall business climate, including the quality of tax regimes and regulatory frameworks, focus on these issues. Arterido et al (2007) find that a weak business environment reduces the employment growth of micro and small firms. Jacobs (World Bank, 2004) proposes a regulatory transition program that allows firms near the margin to accede to the benefits of formality while taking on the obligations gradually over time. Benin has now proposed defining a new "*entreprenant* status," a simplified legal regime intended to facilitate the migration of businesses operating in the informal sector into the formal sector. These types of initiatives are discussed below.

1. Business services

Steel and Snodgrass (2008) emphasize the weak access of informal actors to social services. The services of concern are those with a direct impact on productivity and from which formal firms benefit greatly, such as infrastructure, capital, education, health, and social security. These channels toward greater productivity also involve laws and regulations, as well as private sector development services,

[15] McKenzie, D., and Woodruff, C., 2008.
[16] Fajnzylber, P., Maloney, W. F., and Montes-Rojas, G. V., 2011.
[17] Rand and Torm, 2012.
[18] McKenzie, D. Sakho, Y.S., 2010.
[19] Bruhn, M., McKenzie, D. 2013.

information, and social and cultural norms. According to the framework proposed as a result, the primary objective of policy and economic programs interventions must consist of making these services more accessible to informal sector workers and firms. According to them, we should focus less on legalizing the informal sector than creating a level playing field for agents of the formal and informal sectors.

La Porta and Schleifer (2008) propose the same diagnosis without drawing the same policy lessons about the informal sector. According to them, it is inevitable that there are important productivity differences between formal and informal firms. And, given the importance of productivity in the development process, it is necessary to promote the creation and development of formal sector firms. Gelb et al. (2009) argue that the reasons underlying the observed productivity gap between the formal and the informal have more to do with the access to services from which formal firms benefit and informal firms do not. Access to calibrated training programs could help informal firms to catch up. In most UEMOA countries, there are business development services (BDS) programs that are meant to improve private sector businesses' (including informal ones) access to such services. But their effectiveness has been decidedly mixed, with the majority of cases left unevaluated. In one example, Giugale et al (2000) found that in Egypt, programs designed to promote micro and small enterprises provide a short-term boost to profits for existing firms, but do not foster their growth or development.

2. Skills training

Among all the social services that could benefit informal sector agents, education and training are those that are most cited. Akoten et al. (2006) found that credit is an important input for the growth and development of firms. And yet, one of the determinants of access to credit for firms is the education level of their manager. As a result, a way to develop them in the long-term would be to make education and training available to informal sector firms. According to them, in effect, small and micro enterprises more often face the scarcity of credit than large firms.

Education and training were identified as important vectors that could bring informal sector firms to grow and progressively move towards the formal sector. According to many authors (Atchoarena and Delluc, 2001; Brewer, 2004; Haan, 2006; Niser, 2007) formal education only played a marginal role in informal sector skill development. The types of training offered in formal schools better prepares one for managerial work with little emphasis on the appropriate practical skills development informal sector agents need, such as new product and enterprise programs. According to Adams (2002), the majority of schools that offer training to informal sector agents in Africa are themselves unregistered and informal. This training structure, although it is accessible to informal sector agents, offers services of dubious quality (Johnson and Adams, 2004). Churches and certain NGOs are also seeking to fill this gap, but without much caring for the informal sector agents' needs (Haan, 2006). In the same manner, while firms greatly contribute to their employees' training, this only seems true for large firms and not at all for small ones, and especially not for the informal sector firms. According to Nielson, Rosholm, and Dabalen (2007) only 4.6% of firms with 10 or fewer employees in Kenya, Zimbabwe, and Zambia offered their employees training programs as opposed to 81% of firms with 151 employees or more. As a result, the lack of training confines informal sector agents to low productivity and in turn to low salaries. In face of these constraints, the most used training model for the informal sector in Africa is that of traditional apprenticeship, which has a fairly dubious quality level (Adams, 2002). As a result, to aid informal sector agents to leave the trap of low productivity and salaries, an appropriate training program, involving both firms and the state, should be designed with them in mind.

Improving Skills Development in the Informal Sector (World Bank, Adams, de Silva, and Razmara, 2013) provides case studies of five African countries – Rwanda, Kenya, Tanzania, Nigeria, and Ghana – examining the role of education and skills development in increasing the productivity, profitability and earnings in the nonfarm informal sector. Education and skills development were found to have a strong influence, even though the returns to education were lower in the informal sector than in the formal. Technical and vocational training were found to enhance earnings, while the impact of traditional apprenticeships was mixed.

VI. Recent studies by region: Middle-income countries

In the poorer LDCs where informal economic activity and employment constitute the majority, there seems to be an easy fit for the moniker "informal is normal." However, in middle income countries where education levels are high and the formal private and public sectors dominate, businesses and workers end up in the informal sector for particular reasons, and they have a particular impact on productivity, growth and development.

A. LAC: Multi-country study

Informality: Exit and Exclusion, World Bank, Perry et al. (2007), is a major study of informality in the LAC region and a path-breaking foray into informality from the World Bank. It is based on extensive data collection and hypothesis testing in many LAC countries of varying income levels. It examines the importance of state failures; labor market, business, tax and social protection laws; and the implications of informality for productivity, growth, development and public institutions. Its title refers to two perspectives for looking at the informal sector in Latin America: Informality driven by exclusion from the circuits of the modern economy, and that driven by voluntary decisions of workers and firms to opt out of formal institutions.

Revisiting this work in 2012, Maloney (2012) emphasizes the strong heterogeneity across different types of workers and firms, and notes that firms closer to becoming formal may be more susceptible to policy, though these may be few in number. He reaffirms the value of improving the investment climate in ways that raise productivity as well as improving services associated with formality, especially for SME's. Finally, he reconfirms the value of raising the quality and fairness of public institutions.

B. MNA

1. Privilege

Privilege is a well-recognized hallmark of Middle Eastern economies. As noted in the MNA jobs section above, the benefits of public employment are high enough to engender queuing for jobs, while placement often depends on connections. Those queuing, or without connections, are likely to end up in the informal sector. Systems of privilege affect both the public and private sector in ways that restrict labor mobility and relegate the non-connected to the informal sector.

Indeed, for an extensive study of firm surveys and qualitative interviews on the MENA investment climate, the title itself is indicative: From Privilege to Competition: Unlocking Private-led Growth in the Middle East and North Africa (World Bank, 2009). One quote from the book cites a participant in a high-level seminar on the knowledge-economy in the region: "Why a seminar of the knowledge-based economy? Our economy is totally based on 'knowledge.' To do anything in our country, you have to know someone."

Two important points from that work are noted here: First, among large formal firms, there is a strong sense of who is well-connected and well-protected by the powers that be, and who is not. Outside that rarefied group is a much larger group of small and medium-scale enterprises, many formal and others largely informal in their conduct of business. Finally, there is a large group of overwhelmingly informal micro-enterprises. Second, Government and formal firms express dim views of each other. Each side describes the other as unproductive, rent-seeking and corrupt. It seems that despite this mutual distrust, both sides observe the rules of a game that systematically leads them to a low-level equilibrium. At the same time, privileged firms and informal firms regard each other as unfair competition.

Recent research has made estimates of the value of privilege in two MNA countries. "The Perils of Industrial Policy: Evidence from Tunisia" (Rijkers, Freund, and Nucifora, 2013) found the evidence implies that Tunisia's industrial policy was used as a vehicle for rent creation for the president and his family. "On top of the Pyramids: Cronyism and Private Sector Growth in Egypt" (Schiffbauer, 2013) finds that politically connected firms receive more import protection and more energy subsidy benefits, leading to larger profit margins of politically connected firms versus other large firms. It observes that the presence of politically connected firms is associated with lower competition, lower firm entry, and higher market concentration.

In sum, privilege is a prominent force in the MNA investment climate, strongly affecting the options of private firms, including their degree of informality.

2. Egypt

Privilege takes such a prominent role in Egypt that it comes to define a distinct form of "informality." The 2009 ICA report identifies the following groups of firms:

- formal operators who hide a portion of their activity "in the shadow" by evading some portion of their tax, labor or trade obligations or other rules;
- informal operators who undercut their costs by evading tax, labor, public health and safety, and trade regulations; and,
- Privileged competitors who are not subject to enforcement of formal rules due to their relationship with influential officials.

Galal (2005)[20] estimating the size of the informal sector in Egypt found that 82 percent of entrepreneurs were "extralegal" (1.4 million) and about 39 percent of workers were "extralegal" (more workers than in the formal sector). He posits that Egyptian informal entrepreneurs are willing to forgo the benefits of better protection of property rights and to bear the cost of extra-legality because it is more beneficial to remain informal. He argues that to convince them to become formal, Egypt needs to adopt sufficient reforms so that the net social benefits favor formalization. For example, when Egypt introduced

[20] Ahmed Galal, *Potential Winners and Losers from Business Formalization* Development Outreach, World Bank Institute, March 2005

structural tax reforms in 2005, the new system dramatically lowered tax rates and brought forward 700,000 new taxpayers, an increase of around 47 percent.[21]

For the first time, the 2008 Investment Climate Enterprise survey included 500 informal firms. About 89 percent of the sample consisted of microenterprises with fewer than five employees. Survey results confirm the value of specifying a continuum of characteristics to define informality. The firms surveyed operated in large part legally, with a degree of evasion and noncompliance only somewhat larger than the average small firm in the "formal" sample. In general, firms respond to the costs and benefits of being formal, so reducing the tax and regulatory burden and strengthening access to services for micro and small enterprises are two constructive paths for strengthening the investment climate.

C. South Asia

1. India

A majority of jobs in the Indian manufacturing sector is created in the unorganized/informal segment of the economy according to "Friend or foe or family? A tale of formal and informal plants in India," [Ghani, O'Connell, and Sharma, World Bank (2013)]. Informal firms are an important supplier of inputs to formal firms. Employment and output in the organized sector are greater in those states in India that have a greater presence of unorganized suppliers of inputs. Indeed, there are even strong linkages between the household ("traditional") segment of the unorganized sector and the organized sector. Conversely, unorganized employment and output are greater in states that have a greater presence of organized buyers of inputs. But there are two important asymmetries in the relationship between the organized and unorganized sectors. First, the unorganized sector is much more dependent on and responsive to organized sector presence than vice versa. Second, unorganized sector productivity is dependent on and responsive to organized sector productivity and presence but the reverse is not true. These results contrast with Africa where unorganized firms are important buyers of inputs from organized firms.

The results imply that all industrial policy -- which is usually targeted towards the organized sector -- must take into account the large employment and output spillovers that exist between the organized and unorganized sectors. Secondly, the organized sector remains unlikely to get productivity benefits from the unorganized sector despite the size of employment and output spillovers until the organized sector outsources more higher-end tasks.

2. Pakistan

In "Production vs. Revenue Efficiency with Limited Tax Capacity: Theory and Evidence from Pakistan," [Best et al., London School of Economics (2013)] the authors uncover information about the unreported economy in Pakistan by examining corporate income tax evasion among tax registered firms. Using administrative tax data, they plot the distribution of firms by turnover (or taxable income). In the presence of tax bracket thresholds qualifying for the minimum tax regime, firms have an incentive to "bunch" below the threshold, ie firms with a true turnover slightly above the threshold underreport their

[21] Rita Ramalho, ***Adding a million taxpayers*** (*Paying Taxes Case Study: Egypt*) in World Bank, Doing Business 2008. (Washington: World Bank, 2007)

turnover to remain below the threshold and benefit from the lower tax. By estimating the number of firms in the spike below the threshold, the authors estimate that approximately 66% of corporate income tax liabilities are evaded through misreporting.

VII. Recent studies by region: Low-income countries

In their assessment of the main conclusions of studies of informality in Africa, Mbaye and Benjamin (2014) note especially: the dominant share of the informal sector in African economies to a degree that is greater than anywhere else. In sub-Saharan Africa, the informal sector comprises 50-70 percent of total output and 60 to 90 percent of non-farm employment. Thus study of the informal sector in Africa takes on particular significance.

A. Southern and Eastern Africa

Gelb et al. (2009) compare the productivity of formal firms and informal firms using surveys on the investment climate for a number of countries of southern and eastern Africa. Their results confirm that formal sector firms are on average more productive than informal ones but the gap between formal and informal firms is much less for east African countries than for southern African countries. They attribute this to the difference in the quality of the business environment and the enforcement of rules. The relative weakness of the state in East Africa undermines the performance of formal firms, thereby lowering the gap between informal and formal firm productivity.

They confirm that the quality of the regulations, and especially the power of the state to enforce the regulations, applies to firms by conditioning a large degree of their decision of whether to go into the informal sector or not. According to them, it is necessary to distinguish between two cases: a) the case where we find in the informal sector educated individuals managing productive firms with a large potential to expand; in this case, improving the regulations and access to services could bring them to formalize; b) the case where the regulations are already good and where we only find in the informal sector firms that are developing survival strategies. In this latter case, aiding them with better access to social services will only maintain their survival at best.

They expanded on the Lucas (1978) model to take into account the informal sector in order to test a certain number of the following hypotheses:

1. the most talented entrepreneurs are always in the formal sector,
2. a higher tax rate pushes talented entrepreneurs to the informal sector,
3. informal firms are smaller than formal firms,
4. informal sector entrepreneurs make less than those of the formal sector,
5. informal sector firms are less productive than those of the formal sector.

With their sample of firms from southern and eastern Africa, they validated the hypothesis that entrepreneurs of the formal sector are more educated (education was used here as a proxy for talent) than those of the informal sector. Concerning the productivity difference, they found that the advantages tied to legalization could be weak when services to firms are of bad quality, or when, taking advantage of the corruption of certain state agencies, agents of the informal sector can escape the obligations resulting from informality. This result confirms the thesis in which the weakness of regulations in some states drives many firms with a strong potential to grow to remain in refuge in the informal sector, reducing the productivity gap between the formal and informal sectors in those countries.

B. West Africa

Two significant points have become prominent in research on West Africa: The difficulty of providing a single definition of informality due to the strong heterogeneity among informal firms and the consequent approach of classifying firms according to a continuum of characteristics. Results from Benjamin and Mbaye (2012) confirm the importance of distinguishing the large from the small informal firms in describing behavior and identifying obstacles in the investment climate. While the vast majority of informal firms are very small, the large informal firms play a major role in some sectors, notably commerce.

As noted above, Benjamin and Mbaye (2012) investigate productivity differentials between large and small informal firms in West Africa. The results indicate that large informal firms also have lower productivity than formal firms but the differential is minor, whereas the productivity gap between large and small informal firms is much greater. This result confirms the thesis of Gelb et al. (2009) in which the weakness of regulations drives many firms with a strong potential to grow to remain in refuge in the informal sector, reducing the productivity gap between the formal and informal sectors.

They also examine total factor productivity (TFP) in addition to labor productivity. TFP controls for capital intensity, yet they find the same positive correlation between TFP and formality as for labor productivity. This shows that capital intensity alone cannot explain differences in labor productivity.

They find that large informal firms, in particular, can have fragile structures. They manage large volumes of value added and temporary workers, but they are run like a family firm with a small number of permanent employees, no specialized departments, and seldom survive the death of the owner, or a rupture with political protectors.

The informal sector relies on practices that hinder productivity growth. Their lower productivity may be influenced by the fragility noted above, lack of transparency of their own accounts, long-established traditions based on well-entrenched control of territory and rents, and sub-optimal allocation of productive factors (including reliance on family sources for credit). Informality also prevents companies from acquiring modern management skills and worker training, limiting growth potential and access to the world market. Thus the informal sector contributes to an inimical investment climate for formal firms, particularly foreign investors. Further, the informal sector in general and large informal firms in particular are responsible for a substantial loss of fiscal revenues and narrowing of the tax base.

The informal sector is in part a symptom of institutional deficiencies and the large informal sector, in particular, is a symptom of government failure to enforce regulations that should apply to these firms, as well as the burdensome nature of regulations and taxation that inhibits compliance. For the large informal firms with a genuine choice, policy should be oriented toward a more systematically enforced and enforceable regulatory regime.

Business and government should collaborate on an effort to improve both the business environment and tax compliance, in recognition that each side can take actions that will improve the circumstances of the other. Government can and should move independently to improve public expenditure management and results-based management. And firms can gain in productivity and access to bank credit if they maintain sincere and transparent accounts and pay formal taxes. However, firms prefer to pay taxes when they know others like themselves will also pay, and the business climate especially needs a systematic enforcement of regulations, which requires public intervention. This mutual interest in reforms should be exploited, and such collaboration is more likely to succeed than a unilateral push for new tax revenues from the informal sector. (Mbaye and Benjamin, 2014)

The main positive contribution of the small informal sector is that it provides employment and incomes and thereby alleviates poverty. But the incomes in the informal sector are generally low and low-productivity of the small informal sector suggests limited scope for improvement. The goal of policies overall is to assist small informal sector firms while inducing them to move towards formal sector status in the long run through a combination of services and incentives. Small informal enterprises should not be the focus of efforts to promote growth, however, as their potential is limited. At the same time, enforcement should focus on larger informal firms rather than small firms so as to avoid worsening poverty and unemployment.

C. Household enterprises

Fox and Sohnesen (2013) in a study covering Burkina Faso, Cameroon, Republic of Congo, Ghana, Mozambique, Rwanda, Tanzania, and Uganda, estimate that wage and salary employment in private non-agricultural enterprises is still rare in SSA, accounting on average for only 9 percent of the employed population. The largest category of non-farm employment is Household Enterprises. When asked to report their main reason for starting a household business, push factors dominated the list; not being able to find a wage and salary job was the most frequently cited reason. Further, the HE sector continues to grow due to limited alternatives for those who lack education or access to markets because of remote locations.

According to Fox et al (2013) private non-agricultural wage jobs are unlikely to become a large share of employment in the foreseeable future. It may take a generation before the majority of the labor force has a non-farm wage and salary job. Generalizing this trend to the subcontinent, the number of people entering the labor force will swamp the capability of the formal private sector to respond in even the most optimistic scenarios.

VIII. Conclusion: Recommendations for a productive policy regarding the informal sector

Recommendations from research on the informal sector in a number of regions point to four main areas where development policy can be improved by taking the informal sector into account:

Improvements along a continuum: Two significant points have become prominent in recent research: The difficulty of providing a single definition of informality due to the strong heterogeneity among informal firms and the consequent approach of classifying firms according to a continuum of characteristics. This heterogeneity points to policy options that involve different approaches for firms in different segments of the spectrum. Further, it allows us to make use of observations that aspects of firm performance -- productivity, profitability, employment, longevity -- can be improved along the spectrum, without restricting either policy or results to a simple formal-informal dichotomy. While all of these aspects of firm performance are important, the issues of productivity and employment have the greatest social impact. Informal firms have been shown to have lower productivity than formal firms in all regions. The reasons for this and the best policy response to encourage informal firms to upgrade and improve their performance have not been thoroughly investigated. ***Recommendation:*** Launch a research agenda and action plan to investigate and implement policies that assist small informal firms to improve their performance while encouraging large informal actors to modernize.

Governance and public-private collaboration on mutual reforms: Many efforts to improve firm performance have focused strictly on elements of the production function (more labor skills, cheaper credit) while treating government mainly as a cost (taxes, cost of compliance with regulations). Yet research on informality reveals that many characteristics of the public regime – not only the rules but the nature of enforcement (or lack thereof) -- along with the quality of public services, governance, political privilege, state failures, and many other institutional features that characterize "the system" strongly influence the decisions of firms regarding informality. Further, while firms want better governance and better public services, governments want better tax compliance (as do compliant tax-paying firms). ***Recommendation:*** Launch the kind of practical public-private dialogue that can reveal elements of a public-private bargain that enhances both public performance and private contributions to public finances. Such a dialogue toward this mutual need for reform must include actors from the informal economy and not be confined to constituents focused on defending the status quo.

Skills and business services: Research indicates a strong relation between basic skills and labor outcomes, particularly in the informal sector, despite the sector's lower average returns. Research also indicates the benefits of targeted training programs. Business services programs have a decidedly mixed record, yet ongoing research is refining results on what works best. Further, these programs are the most useful for small household and micro-enterprises, that is, those most likely to be employing the poor. ***Recommendation:*** Pursue the development of worker training and business service programs with a view to improving the capacity of vulnerable participants and improving the performance of the smallest firms along the continuum (as indicated above), but not with a view to formalizing or taxing them. Put in place the necessary incentives and reform packages to encourage large or sophisticated informal businesses to formalize progressively.

Informality and trade: Informal trade is pervasive in developing countries, and the networks developed in informal trade – wholesalers, credit suppliers and money-changers, transporters, retailers – are a strong presence in the informal sector. Research indicates a complex set of relations between informal and formal economic activity in informal trade. It also indicates complex relations between traders and customs services, which in turn sets the tone for relations between the private sector and other public agencies. Yet these kinds of complex and non-transparent trading systems can be discouraging to foreign investors and can otherwise undermine trade policy and the international competitiveness of developing countries. More research is needed to understand how informal trade affects the relations between developing countries and global supply networks; also how informal trade affects other informal economic activity, customs enforcement and border management. ***Recommendation:*** Examine trade policies for elements encouraging informal trade and pursue governance reforms, such as cross-checking between customs and fiscal authorities that can render trading networks more transparent while better integrating developing countries with the global economy. At the same time, the impact of informal trade on the incomes of impoverished border regions should be taken into account, and alternative income sources should be considered. Regional integration initiatives should be mobilized to foster more regional policy coordination to avoid the kind of distortions that set the ground for smuggling between member countries.

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