Policy opportunities and challenges from the COVID19 pandemic

for economies with large informal sectors

Abstract

In the developing world, the informal economy can account for as much as 80% of the population. I focus on the urban component of informality, where both informal employment and informal enterprises are especially vulnerable to the pandemicinduced economic shock. I explain the complex nature of informality, some of the reasons for its persistence and its interdependency with the formal economy, especially in the manufacturing sector, through global value chains (GVCs). Large firms (whether MNEs or domestic firms) subcontract considerable activity to informal enterprises, but this is precarious in character. I suggest the crisis provides the circumstances for greater active engagement with informal actors, by placing informal enterprises on a par with formal firms within industrial policy. I propose integration and registration, as opposed to formalisation, and the provision of state support without taxation. The role of the state is also crucial in matchmaking, creating incentives for GVCs to engage with informal actors systematically, and to reduce the transaction costs for informal actors in such engagement. These actions are likely to provide benefits in the longer run, even if they prove costly in the short run.

INTRODUCTION

The most visible effect of the COVID19 crisis in the developed world has been to the unemployed, the selfemployed, casual and gigworkers, and smallscale entrepreneurs and businesses, which can be imperfectly described as those people and enterprises being in the informal sector. Informality is a universal feature of every economy, a term used to describe workers, activities and enterprises that are not (or weakly) monitored, regulated or registered by the government, and, by extension, have limited or no access to public support. The developed world tends to have low levels of informality, rarely more than a quarter of the population. These actors are fortunate that developed country governments have been able to extend emergency relief, in addition to a preexisting safety net, however imperfect this safety net might be.

In the developing world, informality is a much more pervasive phenomenon, with more than 2 billion people, representing 60% of workers and 80% of enterprises (ILO, 2020). The COVID19 crisis is a stark reminder of the absence of any sort of social safety net. In this paper, I focus on the urban component of developing country informality (Lewis, 1954; Godfrey, 2011; Gollin, 2014; Narula, 2018, 2019) for three reasons. First, the rural economy tends to be overwhelmingly in subsistence agriculture, and less at risk economically from the crisis. Second, the urban poor account for at least half of the population in developing countries, and reside in highdensity localities with precarious sanitary and health conditions. Third, the urban poor are disproportionally dependent on direct and indirect employment in the modern economy (in the sense proposed by Lewis, 1954),1 mainly in manufacturing and service sectors. In the urban arena, international trade and investment often plays a significant role in commercial activity. The urban economy will be the most severely affected by the pandemic, because, even when the country in question has low levels of infection, both demand and supply of goods and services from abroad have been severely disrupted. Even where there has been low domestic mortality, this does not negate the possible economic shock. The more globally integrated the economy through supply chains, the more severe the economic implications of the pandemic (Sforza & Steininger, 2020).

Developing country governments do not always have the resources to implement the basic WHO guidelines to counter the spread of COVID19, although several have effectively tackled previous epidemics and pandemics. The scale and rapid spread of this pandemic may well overwhelm their public health infrastructure and its ability to trace, isolate or test infections. Physical distancing and largescale lockdowns for extended periods are challenging where poverty levels are high and the urban populations are already close to (or below) the poverty line.

In this paper, I emphasise two aspects of informality: informal employment and informal enterprises. I also explain the complex nature of informality, some of the reasons for its persistence, and its interdependency with the formal economy, especially in the manufacturing sector, through global value chains (GVCs). Larger firms within supply chains (whether MNEs or domestic firms) often subcontract considerable activity to informal

enterprises, but this is precarious in character. I suggest the crisis may nonetheless generate the impetus for greater active engagement with informal actors. I propose that this should be done by placing informal enterprises on a par with formal firms within industrial policy. That is, I recommend integration and registration, as opposed to formalisation, and the provision of state support without taxation. The role of the state is also crucial in matchmaking, creating incentives for GVCs to engage with informal actors systematically, and to reduce the transaction costs for informal actors in such engagement. These actions are likely to provide benefits in the longer run, even if they prove costly in the shorter run.

THE INFORMAL ECONOMY INTRODUCED

Table 1 gives a good sense of the significance of the informal economy by region, and a selection of countries. The selfemployed and microenterprises account for almost 70 per cent of employment in the Middle East and North Africa, and for more than 80 per cent in both South Asia and subSaharan Africa (ILO, 2019). India alone officially records 63 million microenterprises, employing 107 million people (Government of India, 2020). The unregistered enterprises, casual workers and subsistence traders likely account for a further 200 300 million. Likewise, Africa has an estimated 300 million are in the informal sector (Jayaram, Leke, OokoOmbaka, & Sun 2020).

Two types of informality are prevalent in an urban economy. The first is informal employment. This refers to workers employed by formal, registered firms on a casual, daywage basis, as well as subsistence actors such as selfemployed workers. This includes individuals and entrepreneurs that might undertake piecework in their own premises, street vendors and most domestic workers. They lack protection for nonpayment of wages and retrenchment without notice, and often work under limited occupational safety conditions with no sick pay and health insurance.

The second group, and the focus of this paper, involves informal enterprises. They engage in coordinated commercial activity, such as bazaar traders, restaurants, and small ad hoc factories. They may or may not have a discernible organisational structure, with operations (and employment) that grows or shrinks, depending upon the demand for the enterprises outputs or services. They are built around an actor/entrepreneur who engages in a

Table 1 Informal employment in the nonmanufacturing sector: selected countries and regions. Source: ILO (2018, Table B.2)

Share of informal employment as % of nonagriculture employment (2016).

Africa 71.9

Nigeria 89

South Africa 34

Ghana 82.6

Uganda 83.4

Developing Americas 49.6

Brazil 42.5

Peru 59.1

Colombia 55.4

Mexico 53.2

Developing AsiaPacific

Indonesia 62.8

80.2

Viet Nam 57.9

Pakistan 70.8

India 78.1

Bangladesh 82

Europe 14.4

Developed Americas 18.9

Developed AsiaPacific 19.5

series of spot market transactions with customers, suppliers and workers, depending upon demand (Geertz, 1963). Informal enterprises are unable to seek (formal) credit, and have limited access to social programmes and public goods. Informal enterprises rarely invest in productivityenhancing equipment, upgrade workers skills, or achieve economies of scale, and tend to function on razorthin margins. They have no recourse to legal protection should their customers renege on payment, and can offer no form of security to their employees, pay no taxes, and ignore minimum wage regulations. For instance, in Bangladesh, workers in the informal sector earn three times less than in formal firms (ILO, 2013).

The supply of lowskilled, lowcost labour in lessdeveloped economies is almost infinite, with considerable movement of surplus rural informal labour to urban locations, where employment in the urban informal sector provides opportunities less dependent on the vagaries of smallscale agriculture. When the economy is characterised by high unemployment, working below minimum wage is better than not working at all. Following the arguments of Lewis (1954), a nearinexhaustible supply of labour in the absence of labour rights

keeps wage costs low, with workers as pricetakers. Lowcost labour is thus a key comparative advantage for most developing countries.

This cost advantage through informality underlies much of the basis for participation in manufacturing value chains, especially in Asia. South Asia exports sports equipment, apparel and carpets, while agricultural products (from beef and wine to grain, tomatoes and coffee) play a significant role more evenly across much of the developing world, especially in Africa and Latin America. A majority of developing country exports are from these sectors, coordinated overwhelmingly by multinational enterprises (MNEs) through global value chains (GVCs). In lessdeveloped economies and in agricultural GVCs, domestic actors tend to have a transactional relationship, selling raw inputs to MNEs. In higherincome emerging countries with manufacturing GVCs, there is a greater domestic engagement. GVCs are vertically deintegrated, relying on a variety of suppliers coordinated by the MNE affiliate. Formal suppliers (whether MNEs or domestic firms) tend to rely on informal employees, and subcontract considerable activity to a network of informal enterprises. Neither public nor private regulators monitor this wide network of indirect suppliers and pieceworkers. The use of the informal sector is an important valve for the formal firms (Narula, 2019). During periods of peak demand, informal enterprises take on tasks for which the formal firm has insufficient capacity, in addition to the formal firm drafting in extra casual workers as needed. Unfortunately, when demand is low, the reverse is the case formal firms can act quickly to reduce costs by laying off informal employees and terminate purchasing from informal enterprises (or simply decline to pay, since they have no legal recourse).

It is uncontroversial that high levels of informality can limit human development. However, reducing informality significantly is no straightforward matter, requiring extended but gradual and sustained engagement with informal institutions that are deeply embedded in political, cultural and structural structures. Indeed, there is little clarity as to informalitys causes, its persistence, or its remedy. What we do know is that a proliferation of informal activity in an economy reflects systemic failures, leading to weak institutions, endemic corruption, and large bureaucratic obstacles (and high entry barriers) to formal activity. Others point to political and regulatory capture by powerful interest groups, for whom a persistent supply of

cheap (and unorganised) labour is an opportunity for rents (Estrin & Mickiewicz, 2012). Political actors may have stakes in perpetuating the status quo. This is especially so in countries with weak political institutions, where inconsistency of policy and weak legal recourse is combined with political biases in favour of elites (Autio & Fu 2015).