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Informality and Growth in Madagascar

REPUBLIC OF MADAGASCAR

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Prepared by Ghislain Afavi, Coffi Agossou, Mokhtar Benlamine, Ialy Rasoamanana, Nombàna Razafinisoa, and Véronique Salins¹

¹ "The authors would like to thank the authorities and development partners for the constructive discussions, comments, and suggestions during the closed-door workshop for its presentation".

INFORMALITY AND GROWTH IN MADAGASCAR

This chapter investigates the link between informality and growth in Madagascar and aims for a better understanding of the informal sector. It provides an analysis of the characteristics of informal production units and informal employment. Findings suggest that informality is a key feature of economic activity in Madagascar, and that informal production units are the main driver of employment with a deep concentration around self-employment. Overall, informality is associated with a lack of awareness of administrative procedures and the complexity and cost of tax and regulatory measures. The informal sector's Total Factor of Productivity (TFP) growth is more stable and higher on average than formal sector TFP.

A. Introduction

1. The concept of informality has evolved over time. Since its introduction in the early seventies, the definition, causes, measurements and implications of the informal sector have generated lively debates. Given its multiple potential associations, the concept remains elusive, making its measurement subject to many criticisms and limitations. These limits constitute an important challenge to statisticians and policy makers, as informality is often associated with paths to circumvent “inadequate” policy decisions. Therefore, recognizing informality’s possible contours and associations is key to design successful policy measures.

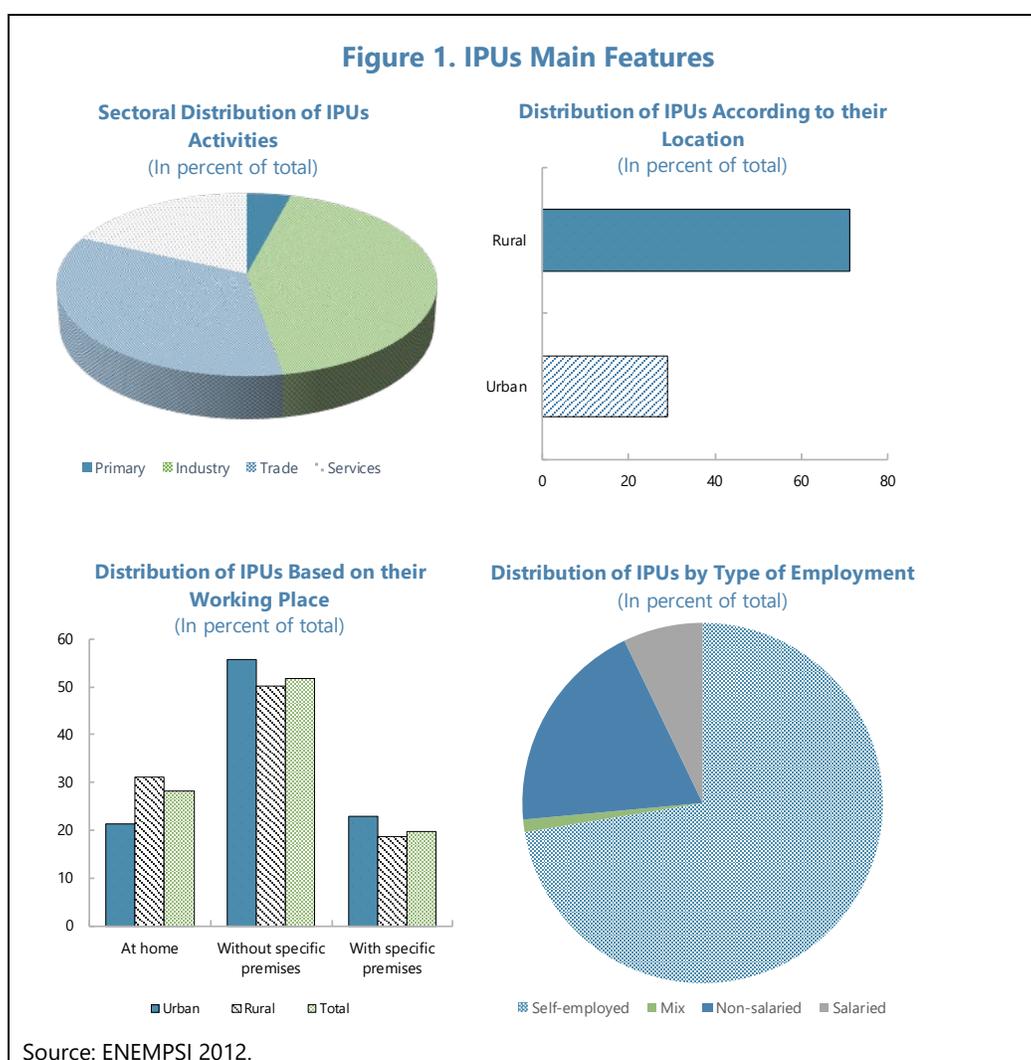
2. Informality is generally recognized as a reality entailing missing legal and administrative compliance. It represents all economic activities carried out by workers or economic units which are not covered or only partially covered – by law or in practice – by formal arrangements. This study is based on the results of the 2012 national survey on employment and informal sector (ENEMPSI in French) conducted by the National Statistics Office (INSTAT), which covers all informal non-agricultural production units in Madagascar. An updated survey has been carried out in 2021/2022, and the results’ dissemination is ongoing with the support of the ILO. The preliminary results, to be published in the coming months, remain broadly unchanged compared to the 2012 survey. The informal sector used in this chapter represents production units that failed to provide statistical identification numbers and written financial records. The criterion of written financial records was introduced to avoid excluding production units which would have a statistical identification number without functioning like formal units (based on the mode of organization and production).

3. This chapter aims to provide a better understanding of the informal sector and investigates the relationship between informality and growth in Madagascar. The rest of the chapter is divided into four sections. Section B describes the key stylized facts of informality in Madagascar. Section C explores the link between informality and the state. Section D explores the link between informality and growth. Finally, section E concludes with some policy recommendations.

B. Stylized Facts of Informality in Madagascar

4. Informal production units (IPUs) play a predominant role in Madagascar's economy.

Almost all individual production units in the country are informal. As of end-December 2012, the country had 2,268,900 individual production units, 99.9 percent of which were classified as informal as they failed to provide statistical identification numbers and written financial records. Their activities are principally concentrated in garment manufacturing (43 percent) and trade (34 percent). IPUs are mostly located in rural areas (71 percent), and typically operate without specific premises (52 percent) or at home (28 percent). Most of these informal units only include one self-employed individual (72 percent) and only 8 percent employ salaried workers. The average size of an informal unit is about 1.4 person. IPUs operate for about 10.3 years on average, with longer lifespan for units located in rural areas and for units operating in both the manufacturing and agricultural sectors. In contrast, IPUs operating in trade and services have a shorter lifespan on average.

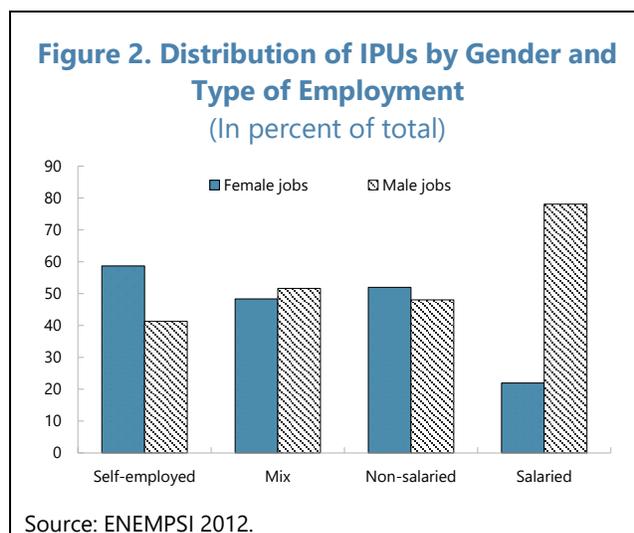


5. The informal sector is the main source of employment in Madagascar. It provides 95 percent of the total employment and is the main supplier of jobs for women (97 percent of

women employment is in IPU vs. 94 percent for men), young people, and people with less to no education. Workers in the informal sector are relatively young with an average age of 35 years compared to 41 years in the administration. Almost one third of the informal workforce are made up of individuals under the age of 26 years. Younger employees often work as paid or unpaid apprentices, or as caregivers. Young people represent only 18 percent of IPU managers. The level of education is low with an estimated average of 4.7 years of schooling. Seven out of ten employees learned on the job and only 2.4 percent have pursued official training. The share of employees with work experience in a large company is as low as 0.4 percent.

6. The Malagasy informal sector is characterized by a relatively high female participation.

Half of the jobs (52 percent) in the informal sector are held by women. Most self-employed workers are women (58 percent). Most family helpers in the informal sector production units are women (53 percent). Nonetheless, women occupy the lowest paid or most vulnerable positions including domestic services to households and other categories of family aid. There is a strong female presence outside agriculture, as the female labor supply is significant and represents 21 percent of female jobs against 14 percent of male jobs. Informal agricultural enterprises mobilize much more male labor than informal non-agricultural enterprises.

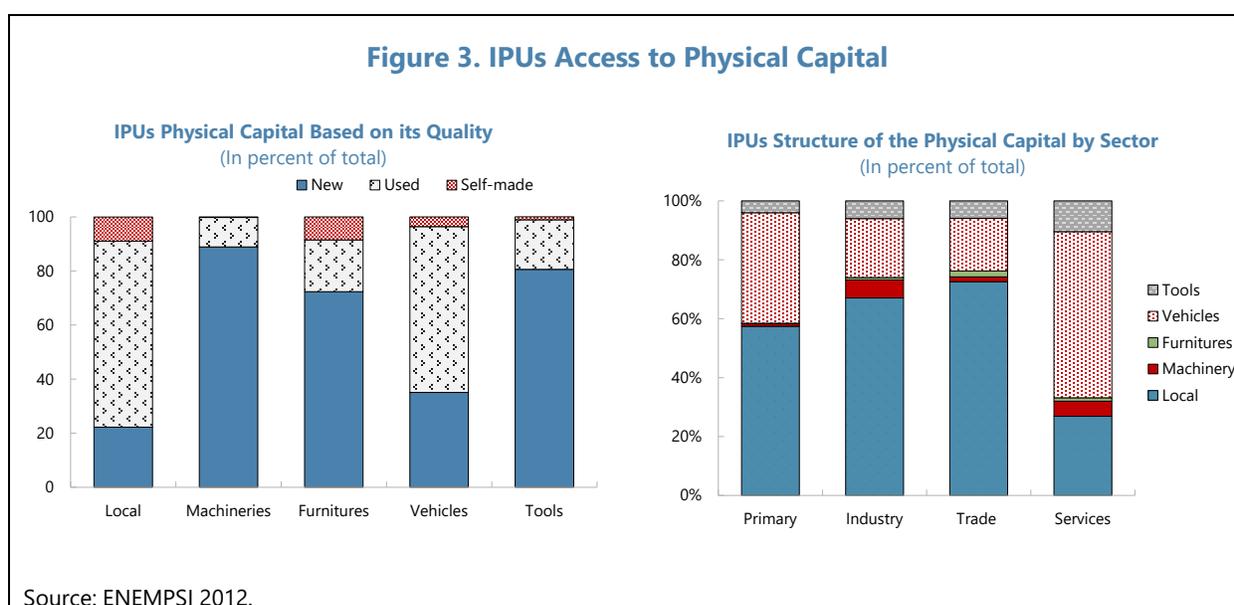


7. Decent work conditions are far from being met and labor regulations are poorly respected in the informal sector. Eight out of ten employed individuals are affected by inadequate employment situations. Only 3 percent of the workers benefit from a written contract; 27 percent have oral contract and nearly 70 percent have no contracts at all. Paid leave is almost non-existent among dependent workers (0.8 percent) and very low among employees (2.5 percent). Informal employees' access to social protection services is very low, with about 97 percent of workers being excluded from the existing contributory social security system. There is no employment protection. Four out of ten dependent (paid and non paid workers and family helpers) jobs and one third of salaried jobs are non-permanent.

8. The informal sector's assets remain low. Informal activities are mostly exercised by workforce with low level of education, skills, and competence. Working hours are less than in the formal sector with the majority of workers in the informal sector not working for more than 35 hours per week (53 percent). The average amount of physical capital remains low at MGA 956,600 (less than 250USD) per unit. Physical capital in informal activities consist essentially of premises (54 percent) and vehicles (33 percent). Machineries and tools count only for 12 percent of the total physical capital. Nearly 60 percent of this capital is purchased on the second-hand market, while

34 percent is newly acquired and 6 percent self-built. About 65 percent of it is personal properties, 23 percent is shared with other IPU and 11 percent is rented. Investment remains very low at about MGA 380,200 (less than 100USD) and is basically used to acquire premises (48 percent) and rolling stock (33 percent). Only 44 percent of the IPU report having invested during the year of the survey, with the investment being only estimated at 8 percent of their value added, highlighting the low accumulation capacity of the sector.

9. Financial borrowing is rare. Over the reporting period, only 3.4 percent of the IPU affirm having recourse to borrowing. Loans come primarily from family and friends (48 percent); microfinance institutions (21 percent) and suppliers (15 percent) and they are used essentially to finance the acquisition of raw materials. Investment is largely financed by individual savings for almost 97 percent of its nominal value, with hardly any use of banking and microfinance services.



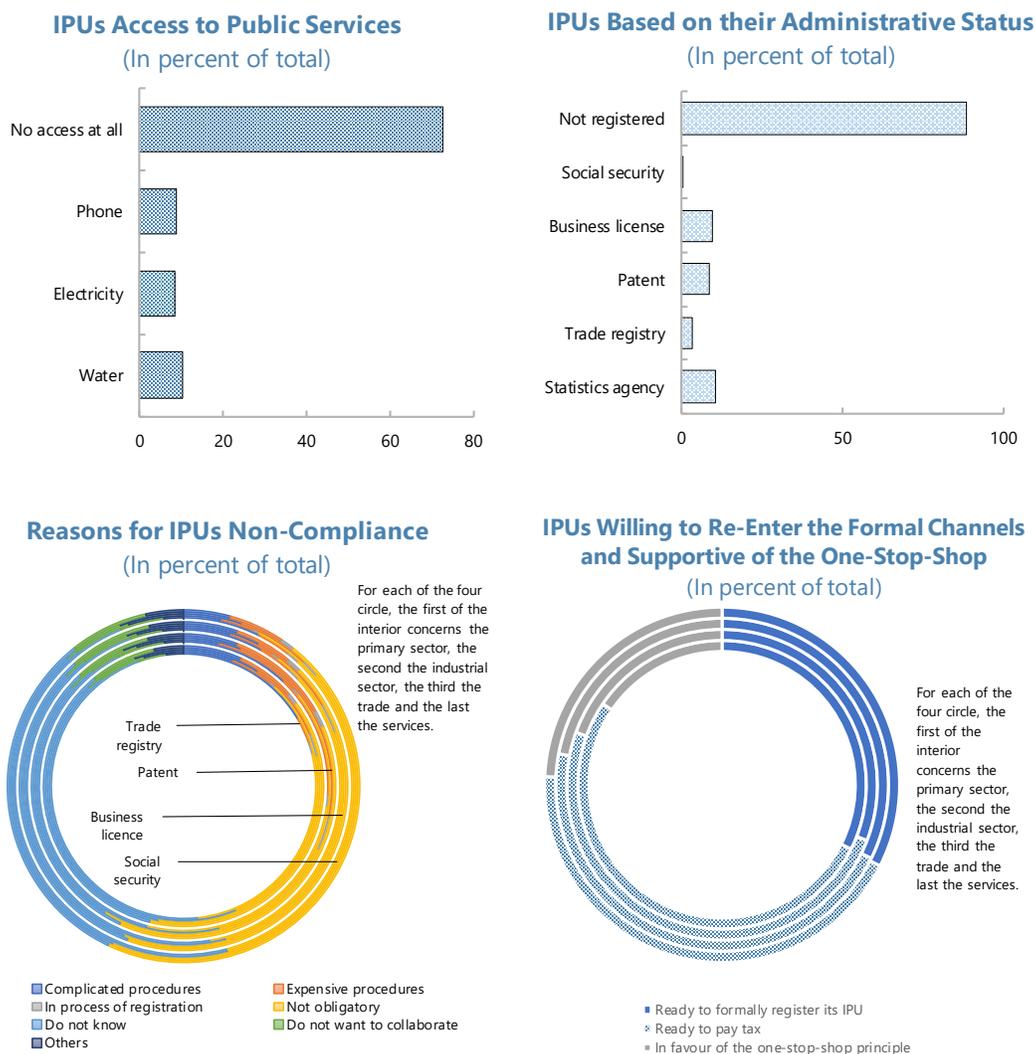
C. The Informal Sector and the State

10. The informal sector has little if no access to public services, particularly in rural areas.

Informal activities are often carried out in an unsafe environment, without access to basic public services. More than eight out of ten IPU are housed in makeshift facilities with only 10.2 percent having access to water; 8.8 percent to phone communication; and 8.4 percent to electricity. The situation is worse in rural areas. Only 9.8 percent of IPU located in rural areas have access to water, 4.6 percent to electricity and 6.4 percent to phone services against respectively 17.7 percent for water and electricity and 14.5 percent to phone services in urban areas.

11. The informal sector is almost completely unknown to the public sector. Nearly nine out of ten IPU are completely unknown to the administrative services. Only 11 percent have a statistical identification number; 9 percent pay the patent (professional tax); 9 percent have professional license and 3 percent are registered at the "Trade registry". The affiliation to the social security system is almost inexistent (0.2 percent).

Figure 4. IPU's Links with State



Source: ENEMPSI 2012.

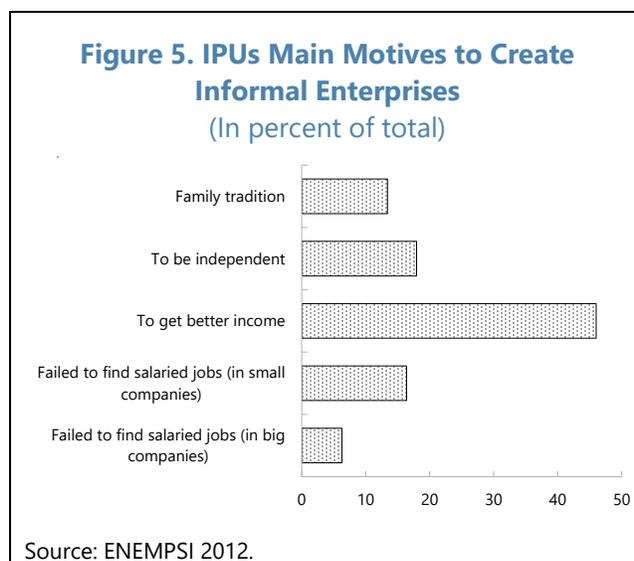
12. Unfamiliarity with procedures (40 percent) and lack of awareness on companies' obligations (33 percent) are the main reasons behind noncompliance in the informal sector.

Only 8 percent of the units consider the procedures are complicated and 7 percent affirm that formally registering is expensive. Additionally, only 6 percent of the IPU's report being informal in order to circumvent the current legislation, to avoid paying a patent, to obtain professional license or to contribute to the social security system.

13. Yet, the informal sector claim they are not against formalizing their activities. More than 40 percent of respondents stand ready to administratively register their companies while 61 percent confirm their willingness to pay taxes. Their main motivations include a better access to market location (25 percent) and higher credit access (14 percent). Some 6 percent of the IPU's have

already launched the registration process but could not finalize due to the complexity and high cost of procedures. Nearly 67 percent of the units consider that taxes should be paid to the local administration (not the central administration) to (i) build infrastructure (44 percent); (ii) invest in health and education (30 percent); and (iii) establish a fund to support micro-enterprises (18 percent). This result underscores the importance that IPUs place on getting a better access to public services to justify taxation.

14. Setting-up informal activities appears to be motivated by the search for higher income and independence. Although, the situation differs from one sector to another, the choice to operate in the informal sector is overall motivated by the hope to get higher income (46 percent); to be independent (18 percent); and to perpetuate family tradition (13 percent). Less than a quarter of the respondents mentions the difficulties to find salaried job in small and large companies as a reason to create an individual company. In the urban areas, the creation of a non-agricultural informal units to compensate for the failure to find salaried employment is higher than in a rural areas, pointing to greater difficulties to enter the labor market in urban areas.



D. Informality and Growth

15. The relationship between informality and growth is a long-standing debate with mixed conclusions. The incapacity to define a unique and consensual measure of the informal production makes the discussion on the relationship between the formal and the informal sectors even more complex, as different studies with different methodologies provide different results. However, we can distinguish between four approaches to informality. In the dualist approach, the informal sector engages in survival activities and operates in isolation from the formal sector. The structuralist approach sees the informal units as subordinated economic units, and informality as an attempt by formal units to reduce their cost of operations to increase their competitiveness. The legalist approach considers the informal sector as a response to a hostile legal system characterized by cumbersome government rules and procedures creating barriers to formalization. Finally, the voluntarist approach sees the informal sector as a deliberate choice made by micro-entrepreneurs weighing the benefits and costs of formality.

16. The contribution of the informal sector to Madagascar's national wealth creation is significant. The informal sector accounted for 43 percent of GDP in 2012. Excluding agricultural activities, the informal sector contributed by 36 percent to non-agricultural GDP, the equivalent of 24 percent of total GDP. Informal trade businesses accounted for 69 percent of the informal sector total turnover, 45 percent of total production and for 46 percent of overall added value. The

manufacturing sector accounted for 15 percent of the total turnover, 28 percent of the production of goods and services, and for 29 percent of the informal sector value added.

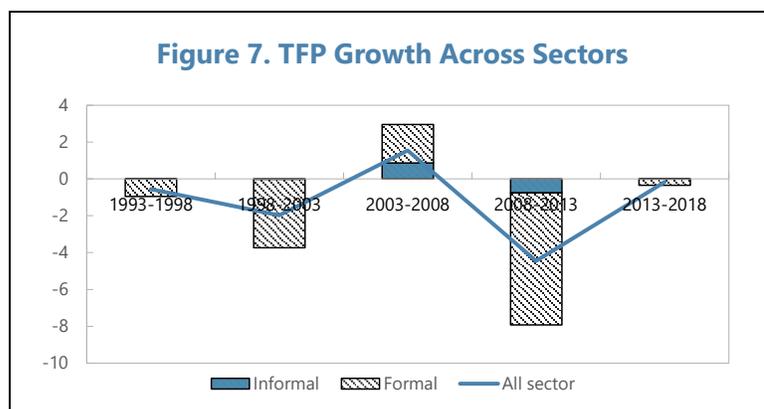
17. However, the informal sector may pose unfair competition to the formal sector. The 2013 World Bank Enterprise Survey highlights that 71.7 percent of formal firms are competing against unregistered or informal firms, and that 19 percent of firms identify practices of competitors in the informal sector as a major constraint.

18. There is a stable long-run relationship between the informal sector's GDP and the formal sector's GDP in Sub-Saharan Africa (SSA). The World Bank's Prospects Group provides a database for the informal economy using several approaches for 196 countries over the period 1990–2018. Using the multiple indicators multiple causes model-based estimates (Schneider, Buehn, and Montenegro 2010) of informal output, we operate cointegration tests on a panel of 40 SSA countries from 1993–2018. We performed three different cointegration tests, which are Kao test, Pedroni test, and Westerlund test. The dependent variable is the formal sector's GDP, and the independent variable is the informal sector's GDP. The results suggest that both series are cointegrated so we can argue for the existence of a stable long-run relationship between the informal sector's nominal GDP and the formal sector's nominal GDP. The result holds for Kao and Westerlund tests. Assuming that there is no cross-sectional dependence in the panel, we found that, the informal nominal GDP does Granger cause the formal GDP (the inverse is also true), which means both variables can help predict each other. However, when controlling for the cross-sectional dependence in the Granger causality test, the Granger causality disappears in both directions. These results highlight the importance of formalizing the economy by providing enough incentives rather than constraining the development of the sector, which will have negative implications on the formal sector as well.

19. Single regressions confirm the existence of this cointegration for Madagascar. Using the multiple indicators multiple causes model-based estimates of informal output for Madagascar, we confirm the existence of a long-term positive relation between the informal and formal economy over the 1993–2018 period. This relation is stronger when controlling for the political crisis of 2002 and 2009. Both formal and informal GDP series are integrated with order one, and the Johansen cointegration tests is conclusive. The residual is stationary at 10 percent.

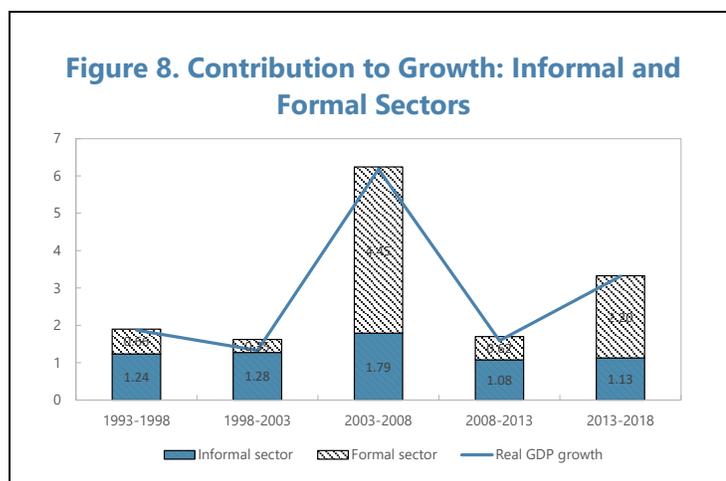
20. The informal sector's TFP growth is more stable and higher on average than the formal sector's TFP growth. We first estimate the TFP of the economy (Annex VI for the IMF staff report on Madagascar of the 2022 Article IV consultation).

Second, we estimated the TFP of the informal sector under the assumption that the sector uses only labor to produce and employ 95 percent of the country's labor force. This assumes that the share of labor in the informal sector is constant, which is consistent with the preliminary results of the 2021/2022 national survey. The TFP is then computed using a linear Cobb-Douglas function. The formal sector's TFP is then computed assuming the TFP in the economy is the weighted average of both sectors' TFP. The weight is time variant and corresponds to the share of each sector in the GDP. The results suggest that TFP growth is heterogeneous across sectors, TFP growth in the informal sector is more stable and is close to zero. These results are in line with previous studies. Grimm and Lay (2011) investigated the dynamics of the informal sector in Madagascar between 1995 and 2004. They find that growth in the informal sector was mostly extensive, with little job creation or capital accumulation and that most activities were expanded through the creation of new firms rather than expanding the existing ones, which is consistent with much higher returns at very low levels of capital. Additionally, using a panel of 135 formal firms collected in 2004 and 2007 in Madagascar, Byiers and Iacovone (2011) compare labor productivity in small informal firms with labor productivity in small formal firms. They find lower labor productivity in formal firms compared to informal firms. The authors explain these results by the high costs of formalization.



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E. Policy Recommendations

21. ILO recommendation R204 on the transition from the informal to the formal economy recommends three ways to complete the formalization process: (i) the creation of decent jobs and sustainable businesses in the formal economy; (ii) the transition of workers and enterprises from the informal to the formal economy; and (iii) the prevention of jobs informalization..

22. Formalizing the economy is in line with Madagascar's Emergence Plan, as stated in Velirano 8: Decent employment for all. This measure is of particular importance due to the effects on other sectoral and specific policies such as ones supporting inclusive growth (improving the productivity and efficiency of production units, equal opportunity for access to markets and means of production), tax policies (broadening of the tax base, transparency and tax justice), employment policies (promotion of decent work, etc.), trade policies (integration in the national or international value chain, competition law), education and health policies (abolition of child labor, improvement of scholarship rate, improvement of working conditions and women's health, etc.).

23. Considering the importance of the informal sector in Madagascar, adjusting policies in favor of the transition from the informal economy to the formal economy is key. With a growing number of people operating in the informal economy in Madagascar, it is felt that a less tax-oriented and a much more social protection-oriented strategic approach is required to stimulate the formalization process. Acknowledging and considering the dynamic of informality and its key drivers and features constitute a first step towards adopting better-tailored policies. To do so, the National Institute of Statistics is currently compiling the results of the 2021/2022 informal survey conducted with the support of the ILO. Ensuring timely and reliable access to this information could help. Additionally, supporting the National Employment and Training Office, responsible for centralizing, analyzing, and disseminating statistical data on employment, as well as the General Directorate of Employment for the strengthening of the Public Employment Service will help overcome the weaknesses of the labor market information system and facilitate matching job supply and demand at the national level. They also could provide orientation, training, placement, and follow-up services.

24. Streamlining labor regulations and strengthening institutional coordination are also key elements in the formalization process. The Labor Code currently in force in Madagascar is governed by Law No. 2003-044 of July 28, 2004. The issue of the informal economy is not considered in this law. ILO has supported the authorities in revising this law, especially in its articles 1, 2 and 3 to better consider the rights of informal workers. The new Labor Code is expected to be submitted to the National Assembly and Senate during the next parliamentary session. The authorities could also (i) promote the creation of formal employment in Madagascar by supporting youth entrepreneurship initiatives and strengthening existing projects (FIHARIANA, etc.); (ii) reform the legal and regulatory standards to conform to the ratified international instruments; (iii) put in place legislation likely to facilitate the transition from the informal to the formal economy by reducing administrative formalities and proposing incentives for IPUs to formalize; and (iv) broaden the social protection system by extending social security coverage to workers in the informal economy (at the level of the CNaPS and other related services).

25. Promoting social security is a priority of the development strategy. This will contribute to the reduction of inequalities and the vulnerabilities of Malagasy workers through the access of rural and self-employed workers to the already existing social security mechanisms, in particular to health coverage for the workers and their families as well as to retirement pension. The promotion of social security to rural workers, who make up 82 percent of Malagasy workers, highlights the

inseparable and complementary link between employment and social protection, one of the priorities and a condition for sustainable development clearly defined in the National Development Plan. The current Social Security Code in Madagascar is governed by Decree No. 69-145 of April 8, 1969, establishing the Social Security Code. Its coverage is limited and requires an overhaul to better meet the current and future challenges and needs. The government has requested the support of the ILO to revise the Social Security Code. A roadmap is being developed for the new code to be available around 2024. Meanwhile, the authorities could explore various mechanisms allowing all workers to benefit from social protection and to improve the offer of services and benefits, on the one hand, and to improve safety and occupational health at the enterprise level, including in the informal sector and in the agricultural sector, on the other hand.

26. Raising public awareness about tax law and procedures is also key, in parallel with enhancing the quality of the tax administration services and reducing the cost of formality and compliance by adopting an adequate legislative framework with micro-and-small enterprises to support the process of formalization.

27. Designing a simplified tax system that accounts for both the characteristics of the informal sector as well as the capacity of the tax administration is equally important (see Box). Although it is hard to tax because of its fragmented nature, the informal sector nevertheless has a non negligible tax potential that could contribute to the country's efforts to mobilize fiscal revenues. This suggests the design of a tax policy that is specific to the IPUs while ensuring its viability via mainly the maximization of the gains while maintaining the taxation costs at an optimal level for the tax administration. Progress in the field of digitalization offers new opportunities for taxing the informal sector.

Box 1. Taxation of Micro-Enterprises in Madagascar

Fostering formalization requires a simple tax system and reduced compliance costs. While Madagascar has recently made significant efforts to reduce administrative compliance costs, the main tax applying to micro-businesses could be further simplified.

The taxation of micro-enterprise is based on a flat rate levy. A single combined tax (*Impôt synthétique, IS*) of both income tax and VAT applies to business or individuals with a turnover lower than MGA 200 million (about USD 50 000) per year. The tax represents 5 percent of the businesses' turnover with a minimum tax of MGA 16 000. However, 2 percent of the amount of purchases of goods and services can be deducted from the tax as long as the business can provide invoices in line with the model established by the tax authorities. The same applies to personnel costs as long as they are subject to the personal income tax (IRSA, *Impôt sur les Revenus Salariaux et Assimilés*). The is complemented by *the Impôt Synthétique Intermittent (ISI)* which specifically targets the informal sector. Registered persons or businesses purchasing goods or services from the informal sector are required to withhold 5 percent of the amount paid (the rate climb to 10 percent when the transaction implies non-residents).

The tax system applying to micro-enterprises could be further simplified to avoid imposing a relatively large tax burden or significant administrative costs on micro-businesses. A tax rate of 5 percent of turnover can be significant for businesses with relatively low profit margins. And, while it can be reduced to 3 percent based on registered purchases of goods and services, benefiting from this deduction significantly increases administrative burden for micro-businesses which may not have the capacities to carefully account for all their operations. In this context, the authorities could envisage lowering the IS rate

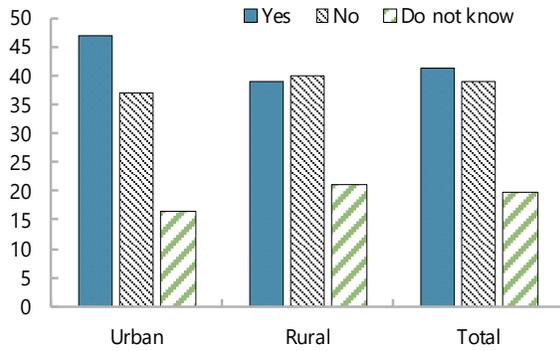
while keeping the minimum of perception. In addition, it would be also important to ensure that the IS rate is lower than the ISI rate to efficiently promote formalization.

With unfamiliarity with procedures and lack of awareness about companies' obligations being the main reasons cited behind non-compliance in the informal sector, it is essential to ensure that tax compliance is not too cumbersome. In this regard, recent efforts from the tax authorities to simplify procedures for registration and IS payment, including by digitalizing the declaration and payments processes are welcome. Stabilizing the system and avoiding conflictual signaling - by unduly questioning the eligibility to the regime and using excessive tax controls after the formalization of the units - are also key elements to build trust in the taxation system and facilitate the formalization process.

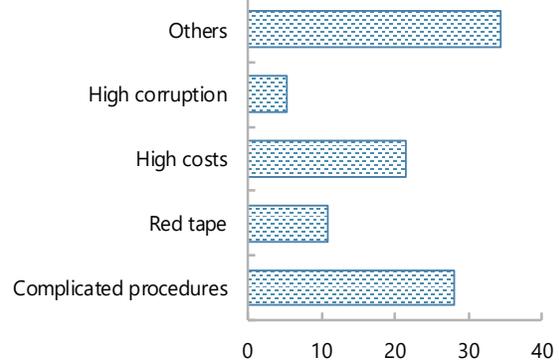
28. Alleviating financial constraints to increase and facilitate access and reducing the cost of financial services would support higher investment. To facilitate access to financing, the authorities could (i) set up a national guarantee fund with subsidized rates and a start-up fund to help companies to be compliant with regulation; (ii) design and implement effective regulations that reconcile financial stability and the opening of new financing channels for businesses; (iii) encourage investors' participation; and (iv) support the private sector through setting up a development bank and bringing more resources to formal financial intermediation at lower costs.

Figure 9. Informal Sector Key Characteristics

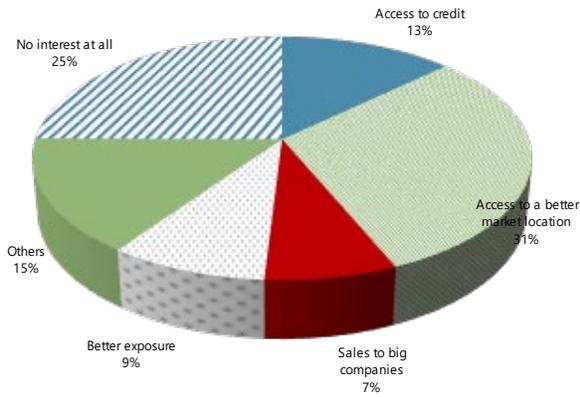
IPUs Based on their Willingness to Register their Business
(In percent of total)



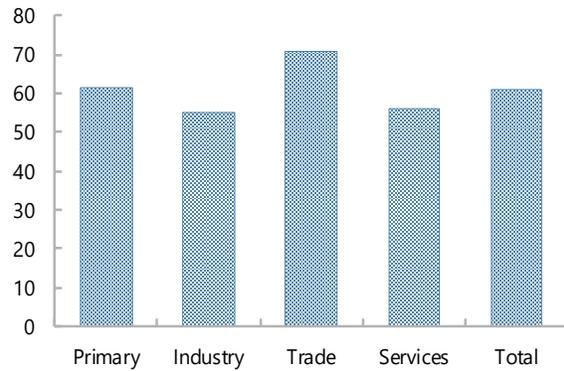
IPUs Based on the Reasons for not Completing the Registering Process
(In percent of total)



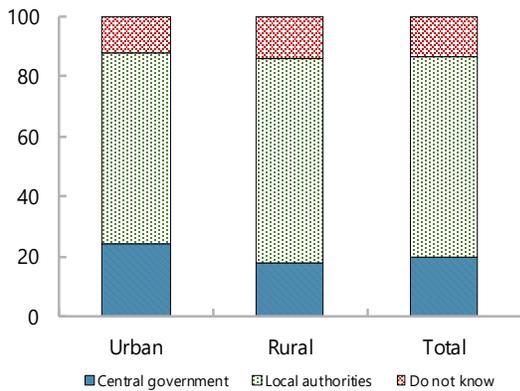
IPUs Based on their Main Interest to Register their Business
(In percent of total)



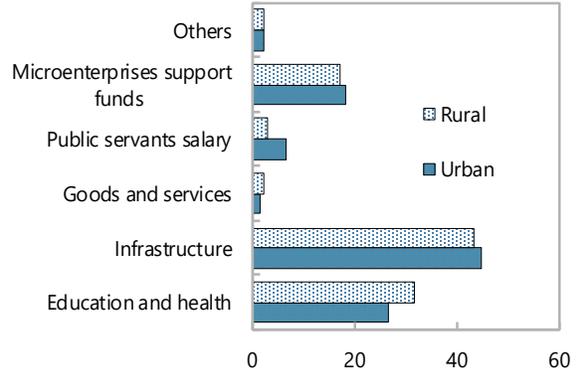
IPUs Based on their Willingness to Pay Tax
(In percent of total)



Main Beneficiaries of Tax Payment According to IPUs
(In percent of total)



Distribution of IPUs by the Uses of Collected Tax
(In percent of total)



Source: ENEMPSI 2012

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