

POLICY BRIEF

Strategies for Transforming Businesses from Informal to Formal



Photo credit: ADB.

Policies being undertaken in the Pacific are helping businesses move from the informal to the formal sector and generate better jobs.

Introduction

One of the Pacific economies' distinctive characteristics is the informal sector's significant contribution to growth and employment. The informal sector is broadly characterized as "unregistered and/or small unincorporated private enterprises engaged in the production of goods and services" (ILO 1993). Typically, informal business operations are small scale, without contractual arrangements and division between capital and labor, and generate income and employment exclusively for the persons concerned. In this analysis, the informal sector includes subsistence agriculture.

Subsistence workers account for a significant proportion of total employment in developing member countries (DMCs) of Asian Development Bank in the Pacific (Table 1). They constitute more than half of total employment in the Federated States of Micronesia, Solomon Islands, Timor-Leste, and Vanuatu.

The sheer size of subsistence employment has at least two implications. First, the informal sector

essentially serves as a natural economic shock absorber. It allows workers to exit the formal sector temporarily and, rather than being unemployed, earn subsistence income. Therefore, low unemployment rates in some Pacific DMCs (e.g., Solomon Islands, Timor-Leste, Tonga, and Vanuatu) should be interpreted with caution because it may mask a high incidence of underemployment.

Secondly, the informal sector's disproportionately large role in the labor market poses a pressing challenge to sustainable growth and development in Pacific DMCs. Subsistence workers have no access to employment protection and external credit, and are financially vulnerable to shocks. Except in Papua New Guinea, there is no legislation recognizing the informal sector's contribution to subsistence employment in Pacific DMCs.

The absence of legislative and policy frameworks to systematically address subsistence labor development hampers improvements in overall labor productivity and business operations.

Table 1: Contribution of informal sectors to employment

Country	Employment ('000)	Unemployment (% of labor force)	Subsistence workers		
			('000)	% employed	Year/Source
Cook Islands	6.2	8.2	0.1	1.8	2011 Census
Fiji	369.3	6.9	8.3	22.5	2010-2011 EUS
Kiribati	28.0	30.6	7.8	27.7	2010 Census
Marshall Islands	11.1	30.9	0.4	3.5	1999 and 2011 Census
Micronesia, Fed. States of	31.3	16.2	16.4	52.4	2010 Census
Nauru	3.1	23.0	0.1	4.1	2011 Census
Palau	8.4	4.1	0.2	2.0	2012 Census
Papua New Guinea	2,713.1	6.4	1,112.4	41.0	2009 HIES
Samoa	40.7	5.7	14.5	35.6	2011 Census
Solomon Islands	220.0	3.2	170.7	77.6	2009 Census
Timor-Leste	284.2	3.6	198.5	69.8	2010 LFS
Tonga	30.2	1.1	8.6	28.6	2011 Census
Tuvalu	4.2	16.3	1.8	43.0	2004-2005 HIES
Vanuatu	108.9	4.6	65.0	59.6	2009 Census

EUS = Employment and Unemployment Survey, HIES = Household Income and Expenditure Survey, LFS = Labor Force Survey.

Note: This policy brief adopts the International Labour Organization definition of subsistence workers as "workers who hold a self-employment job and in this capacity produce goods or services which are predominantly consumed by their own household and constitute an important basis for its livelihood."

Source: ADB estimates based on latest population and housing censuses, household income and expenditure surveys, and labor force surveys.

Analysis

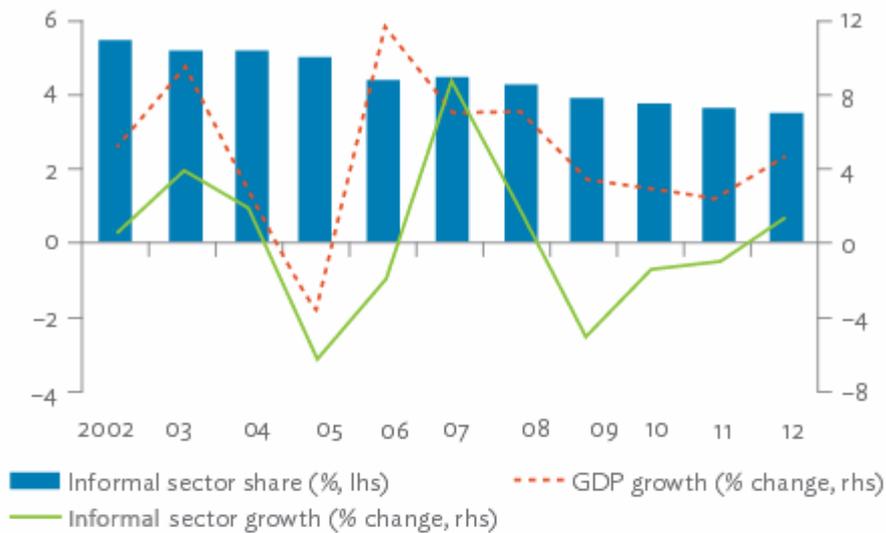
Declining importance of the informal sector

The contribution of the informal sector to total gross domestic product (GDP) generally declines as an economy develops (UNESCAP 2007). Rising demand results in more economic opportunities, allowing more businesses and workers to move into formal market-based operations. Therefore, the formal sector's crowding out of the informal sector is not surprising; it is part and parcel of economic development. Since formalization of an economy signifies more effective taxation, government regulations, and social security systems, it should be deemed as a step toward higher levels of economic development.

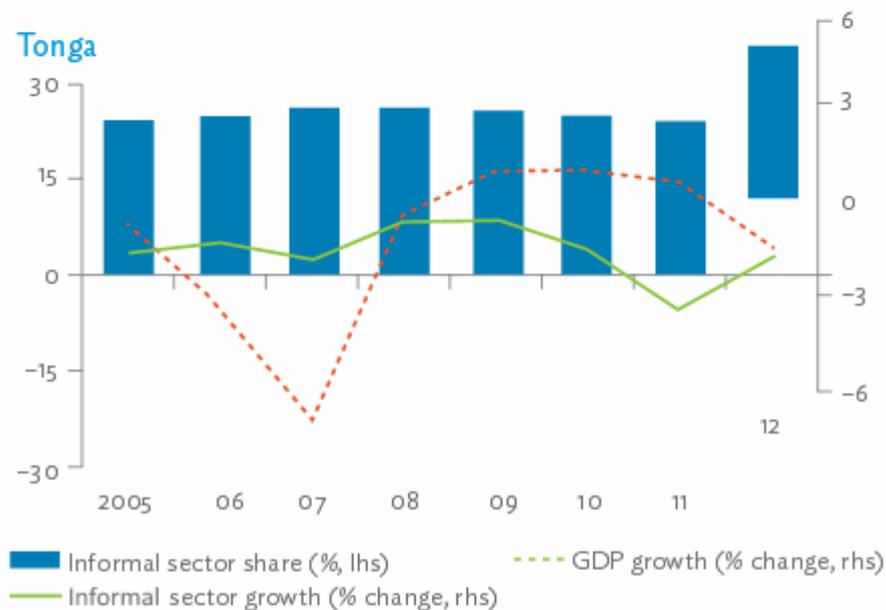
In the Pacific, this is illustrated by the Cook Islands, where the informal sector accounted for approximately 3% of total GDP in 2012 (down from 6% in 2001) (Figure 1). Comparing informal sector and overall growth shows that the declining share of GDP could be attributed to the relatively faster growth in the formal sector. The informal sector generally underperformed vis-à-vis the overall economy by 0.4%, on average. As the formal economy grows, more labor is usually reallocated toward the formal and away from the informal sectors.

Figure 1: Informal sector shares and growth

Cook Islands



Tonga



GDP = gross domestic product, lhs = left-hand scale, rhs = right-hand scale.

Notes: (i) Informal sector includes subsistence GDP in agricultural sectors; (ii) GDP growth is measured at constant prices and on a year-on-year basis.

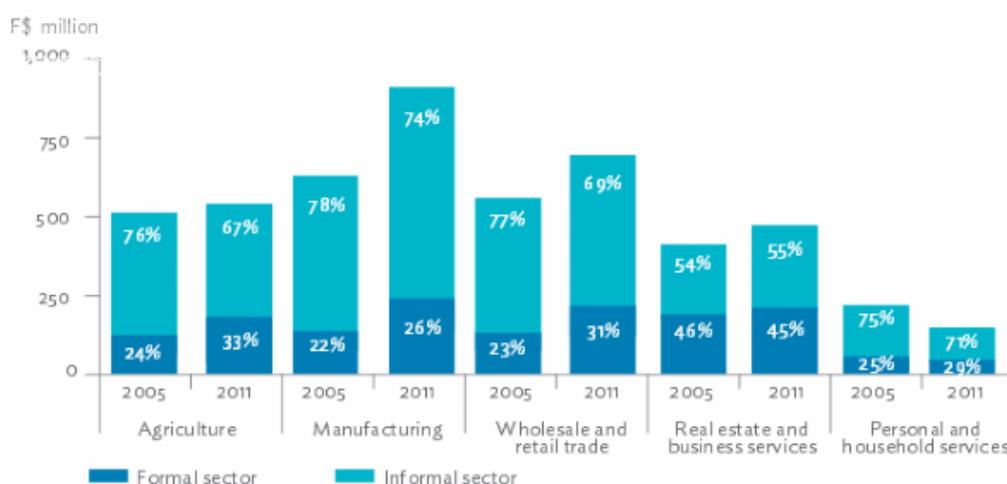
Sources: The Cook Islands' Ministry of Finance and Economic Management and Tonga Department of Statistics.

However, the decline in the informal sector can be stalled or reversed by adverse economic shocks. In the case of Tonga, civil disturbances in 2006 drove a temporary expansion in the informal sector. With a subdued formal economy, businesses and workers resorted to informal activities to generate income. The role of the informal sector as a hedge against economic shocks is illustrated by the steady growth in informal sector output while the overall economy contracted. More recently, the informal sector's share in GDP has been declining as the economic situation in Tonga steadily improved.

The case of Fiji further highlights possible impacts of political and economic disruptions on the size of the informal sector. The 2006 military coup, the country's second in a span of 6 years created significant

uncertainty in the business and economic environment. Heightened uncertainty suppressed private investment, and likely pushed some businesses and workers toward the informal sector. The relative size of the informal sector increased slightly from 14.3% of GDP in 2005 to 15.4% in 2011. Comparing formal and informal contributions to GDP by sector further underscores the expansion in informal activities during the period of high market uncertainty (Figure 2). The largest increase was in agriculture, where the informal sector's share of sector GDP increased from 23.6% in 2005 to 33.3% in 2011. Wholesale and retail trade (23.1% to 30.7%), personal and household services (24.6% to 29.0%), and manufacturing (21.9% to 26.0%) also saw notable shifts toward greater informal sector output. The economic disruption caused by the coup depressed domestic demand and may have caused smaller formal businesses to cease operations. Further, political and business uncertainties reduced private investment, including foreign investment, thereby limiting the opportunities for any large new business ventures.

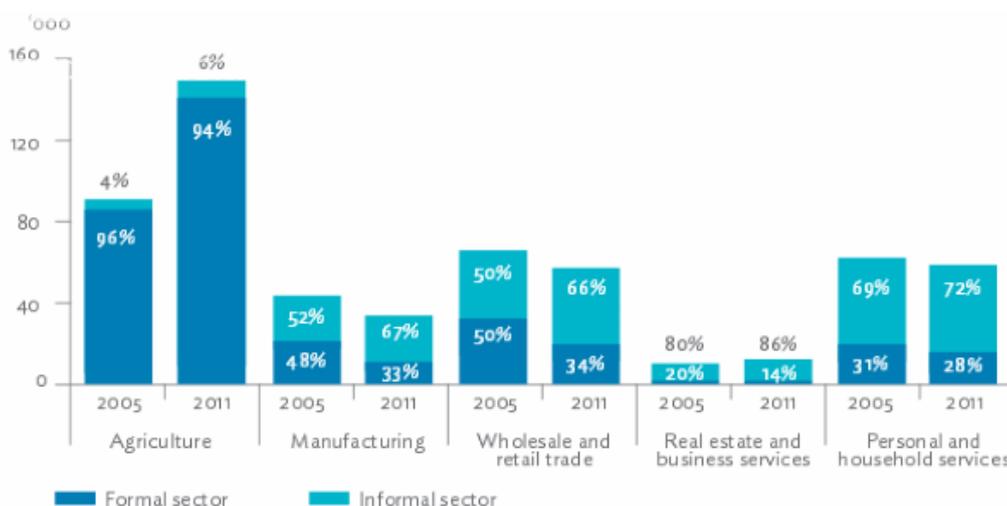
Figure 2: Formal vs informal sector gross domestic product by economic activity in Fiji



F\$ = Fiji dollar.

Sources: ADB estimates based on Fiji Bureau of Statistics data.

Figure 3: Formal vs informal sector employment by economic activity in Fiji



Note: Subsistence workers refer to those who are not paying Fiji National Provident Fund contributions, including those with both money and subsistence income and those with

only subsistence income.

Source: ADB estimates based on Household Income and Expenditure Surveys and Fiji Bureau of Statistics.

The expansion in informal sector output is also mirrored in the labor market (Figure 3). Data from Fiji's 2004–2005 and 2010–2011 employment and unemployment surveys allow for a crude measure of informal employment—the number of workers who are not paying Fiji National Provident Fund contributions. Using this simplified measure, the share of informal employment edged up slightly from 57.1% of the total in 2005 to 58.4% in 2011.

While informal sector shares in employment declined across subsectors, the rise in the number of subsistence workers in agriculture was substantial. The increase in informal agriculture employment is almost double the net decline across all other sectors. Thus, subsistence agriculture appears to have absorbed not only former industry and service workers but also the bulk of new labor market entrants during this period. This highlights the “natural economic shock absorber” role, in particular, of informal agriculture. Engaging in informal agriculture activities allows workers to support their livelihoods through subsistence or small-scale production for sale during times when employment opportunities in the formal sector are limited. Periods of economic crises or prolonged uncertainty can therefore push workers to the informal sector, at least temporarily, until they return to formal sector work when conditions normalize.

Conclusion

While informal sector output and employment can be expected to decline as an economy develops, episodes of economic uncertainty and stagnation can stunt the increasing formalization of economic activities. The case of Fiji highlights the importance of developing and maintaining a sound business environment to sustain a transition from informal to formal sector activities. As Fiji prepares for a return to representative government, policy transparency and predictability is seen to improve and this should reinvigorate private investment and formal sector activity in general.

The transition from informal to formal sector activities, in principle, is an encouraging sign of economic development. The formal sector is typically more productive than the informal. It is also subject to government taxation and social security contribution, thereby making the overall economy more conducive to sustainable growth.

Nevertheless, this trend implies that the formal sector, particularly the private sector and small and medium-sized enterprises, will become much more crucial to job generation than ever before. To ensure that formal sector growth can be translated into job creation, it is essential that appropriate labor laws and regulations are implemented, sufficient social and employment provided, and private sector development in policy agendas advocated.

Resources

International Labour Organization. 1993. *Resolutions concerning statistics of employment in the informal sector adopted by the 15th International Conference of Labour Statisticians*. January.

UNESCAP. 2007. Improving employment opportunities in Pacific island developing countries. *Small Island Developing States Series*. No.1. Fiji.

Related link

Policy Brief: Informal Sector Growth and Employment in the Pacific (originally published in the Pacific Economic Monitor July 2014)



Aekapol Chongvilaivan
Young Professional, Asian Development Bank

Aekapol Chongvilaivan has worked with the economic team of the Pacific Department on various knowledge products, including the Pacific Economic Monitor. He is now assigned at the Southeast Asia Department where he serves as an economist in the regional cooperation and operations coordination division.

Ruth Francisco
Consultant, Asian Development Bank

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Rommel Rabanal
Senior Economics Officer, Asian Development Bank

Rommel Rabanal is a regular contributor to the Pacific Department's quarterly macroeconomic monitoring and surveillance cycle. His other responsibilities include analytical contributions to knowledge products, and periodic capacity building missions to Pacific countries on fiscal and economic analysis.