How Do the Informal and Formal Sectors Interact?

Formerly seen as two separate markets in terms of supply and demand, the formal and informal sector may be more intertwined with each other than previously thought. Recent research explored the question in what way the formal and informal sector interact with each other and what these inter-linkages mean in a dynamic context. Formerly seen as two separate markets in terms of supply and demand, the formal and informal sector may be more intertwined with each other than previously thought. Recent research explored the question in what ways the formal and informal sector interact with each other and what these inter-linkages mean in a dynamic context. More specifically, what types of transactions (sells/purchases) take place between formal and informal firms, and are household’s consumption patterns of formal and informal goods and services?

Linkages between the Formal and Informal Sectors

The interdependence of economic actors plays an important role in the dynamics of economic development. The underlying assumption is that if all firms do not buy intermediate goods from independent suppliers but rather produce their inputs themselves, benefits from specialization and economies of scale are reduced, ultimately constraining dispersion of technical innovation and growth. In this respect the informal economy is no different than its formal counterpart. Productivity and growth depend on the vertical linkages of an enterprise especially if production involves several intermediate steps and products. Moreover, at the end of the production chain, the sales are determined by the ultimate demand and distribution of the goods, which may be formal or informal in nature.

The linkages between formal and informal markets can be divided into production and consumption linkages. The former are defined as backward linkages if the firm purchases a product from an intermediate supplier for its own production; or forward linkages if it supplies another firm with an intermediate product. All of the involved can either be formal or informal entrepreneurs. The latter linkages concern the final demand by the consumer who may herself be active in the formal or informal sector and who may purchase a product via informal or formal distribution channels. It is important to understand the degree to which the informal and formal sector are linked to each other in order to derive policies for economic growth in the informal sector.

Results on Production and Consumption Linkages

According to the research based on the 1-2-3 survey comprising data on informal entrepreneurs collected in seven capitals of the West African Economic and Monetary Union (WAEMU), about 80 percent of informal production units (IPUs) produce for consumers directly. So-called forward linkages (i.e., sales to other producers and especially to the formal sector) are very limited and, if made, only by IPUs that have better capital endowment and are registered (yet still informal). Smaller low-capital IPUs have practically no forward linkages to the formal sector—a circumstance
that a number of business owners see as a disadvantage of being informal.

Backward linkages to the formal sector are more prevalent. These linkages vary with the degree of informality, occurring less frequently if firms are unregistered or have low capital stocks. Moreover, they are more likely to exist for IPUs with a higher number of employees as well as better access to credit and telephone services, and where the owner is male and has more years of schooling.

Using various measures of firm performance, the existence of formal backward linkages is strongly correlated with firm performance, whereas the degree of informality of the enterprises seems to affect performance only indirectly through their linkages to the formal sector. This suggests an important role of formal linkages for firm performance, although it is difficult to establish causality with the cross-sectional data at hand.

With respect to demand by consumers for informal products and services, the research yields three main insights. First, there are substantial demand linkages between the channels through which goods are distributed in the formal and informal sector. More than half of formal goods (incl. imports) are marketed through informal distribution channels. However, informal products are almost exclusively distributed informally. In the food and beverages sector, for instance, formal outlets such as supermarkets appear to be virtually non-existent for informal goods.

Second, informal households account for a considerable share of overall expenditures on formal goods and goods sold via formal distribution channels. Regulations pertaining to the formal sector such as pricing or competition policies are thus likely to affect equally the welfare of those working in the informal sector. Likewise, formal households consume a considerable amount of informal products and products distributed informally.

Third, rising household income leads to a lower propensity to consume informal sector goods and to use informal distribution channels. This implies that growing demand induced by higher incomes, even if all other factors remain the same, leads to a transition from informal to formal activities. At the same time, demand elasticities for informal goods and distribution channels are generally not too far below and in some cases even above unity, which points to a slow and uneven transition process.

A Fluid Market

Overall, the main message is that linkages rather than a formal-informal dichotomy characterize the demand structure in the studied West-African economic centers. Consequently, a comprehensive policy strategy should not treat the informal sector in isolation.

Larger IPUs are generally better integrated than previously assumed while smaller ones remain separate from the formal economy. The latter may benefit from policies that support options increasing interaction between the formal and informal sector, thereby decreasing bottlenecks and smoother integration. Still, more research is needed to study the nature of the linkages and to develop such options, which likely vary across countries and sectors.

Results further showed that the demand for formal and informal goods by formal and informal households overlaps with each group having a substantial demand for products of the other group. Hence, a thriving formal economy might indirectly benefit the informal sector through this demand linkage. Still, the clear predominance of the informal distribution channel for informal goods suggests that measures to improve its efficiency should figure more prominently on the policy agenda. Moreover, looking at demand elasticity showed that an increase in income shifts demand from informal products to formal products. For example, households may start buying more in supermarkets rather than informal markets as their incomes increase. Consequently, for those staying behind in the informal sector support may be needed for a long time to come.

References
