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The Informal Sector: An Exposition on its Origins, Current State and Future Prospects

In developing economies, it is visible everywhere. It is amorphous, difficult to define, challenging to measure, generally beyond the grasp and, indeed, comprehension of the authorities. Yet the informal sector accounts for a significant share of the economy and directly impacts the lives of a majority of the population. Fifty per cent of the global workforce is estimated to be employed in the informal sector (OECD, 2009). What is the informal sector? Why does it exist? How does it impact the quest for growth and equity?

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Introduction: The Informal Sector

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Its size, pervasiveness across sectors and economies, its impact on the well-being and progress of a large proportion of the global work-force, raises a number of questions. What is the informal sector? How has thinking on the informal sector evolved? Why does the informal sector matter? Why do individuals and businesses choose to enter the informal sector? ‘Informality’ entails obvious costs – why do firms and individuals often opt to remain in the informal sector? The absence of regulatory oversight and control poses challenges for policymakers. Should the informal sector be curtailed and all activities be brought under the rubric of ‘formality’? Is there a rationale for a nuanced approach letting segments of the informal sector continue as they are, with minimally intrusive regulatory oversight that does not impair aspirations and abilities for decent livelihoods? Does the informal sector fill a missing market that the official sector cannot provide? Can an economy’s welfare be enhanced with the co-existence of an informal sector along with the ‘official’ sector? Conversely, what social and economic functions are filled by the informal sector?

The case for paying attention to the informal sector has been bolstered by recent research findings showing that in many countries and across a number of sectors, informal activities contribute to income generation, help alleviate poverty and enhance resilience of households. The pioneering work in this area was carried out over the past two decades at multilateral institutions, especially the International Labour Organisation [ILO] (ILO, 2002, 2013; WIEGO 2014).

Structured as an essay, this paper seeks to address these questions. The next section provides an overview of how thinking on the informal sector has evolved since the end of the Second World War. This helps to contextualise policy initiatives in this sector. This is followed by a review of significance of the informal sector for the economy, specifically its impact on employment, productivity and poverty reduction. The paper then briefly discusses how globalisation impinges on activities in the informal economy. The paper also discusses how regulation impacts the informal sector. It concludes with a brief discussion on how the sector is likely to evolve in the near future.

What is the Informal Sector?

Informal activities straddle the spectrum from illegal to legal to seemingly mundane. Trade in drugs, human trafficking, the sex trade, money laundering, sweat shops and the underground arms trade epitomise the illegal part of the informal sector. Illegal activities are socially and economically undesirable, and require a concerted international effort to stamp out. However, most informal activities, though beyond the purview of regulation are legitimate activities, even where they may not be officially sanctioned. Over the past few years, issues revolving around the role of refugees and economic migrants in the farming sector, in sweat shops, in domestic services, in restaurants and in the underground economy have also shifted to the forefront of the debate on migration.

The discussion in this paper focusses on a wide spectrum of economic activities that are legal but unofficial or ‘informal’, but contribute to employment, productivity, output and social welfare. Definitions of informality differ across countries and sectors. In this paper, the informal economy is defined as “market-based legal production of goods and services that are deliberately concealed from public authorities to avoid payment of income, value added or other taxes; to avoid payment of social security contributions; having to meet certain legal labour market standards, such as minimum wages, maximum working hours, safety standards, etc.; and complying with certain administrative procedures, such as completing statistical questionnaires or administrative forms” (Schneider, Buehn, and Montenegro, 2010). It does not include the rapidly evolving ‘gig’ economy in its analysis.

Evolution of Thinking on the Informal Sector

Research on development economics gained momentum in the early 1950s as newly independent countries in Asia and Africa, and developing economies in Latin America embarked on the path to growth. W Arthur Lewis’ work (Lewis, 1954) on development postulated that as the modern industrial sector grew, economic prosperity and the right mix of policies would gradually result in informal sector activities being absorbed into the formal sector. This was the ‘turning point’ at which subsistence wage levels rose to the levels in the organised sector. This was borne out by the experience of developed economies in the West

and Japan. In the developing world, however, growth rates were slow or stagnant, resulting in widespread disguised unemployment and under-employment, characterised by Lewis as the ‘dual economy.’

Hans Singer (1970) characterised this as dualistic development. Differences in technology, capital and labour skills resulted in low levels of investment, small-scale production and under-employment in the traditional sector while a modern sector embodying new technologies and large scale production, financed through capital markets, grew alongside the ‘traditional’ sector. This dualistic development raised concerns about enduring inequalities and patterns of development that ran contrary to the predictions of received theory.

This pattern of growth that ran contrary to the predictions of traditional economic models led the ILO to sponsor pilot research into employment patterns in Kenya, Ghana and several other developing countries. A 1973 study by Keith Hart, a British anthropologist, found evidence of small profitable businesses financed by small savings that helped keep families above the poverty level (Hart, 1973). The term ‘informal economy’ is attributed to Hart. Similar research in other countries reinforced the findings of sustainability of these micro-businesses.

Till well into the 1980s, mainstream economists as well as some multilateral institutions epitomising the ‘Washington Consensus’ deemed informal sector activities to be a distortion. They were considered to be unproductive and incapable of growing beyond subsistence level. For policy-makers and most researchers, the inability to measure these activities and influence them through policy initiatives kept interest levels low.

The first systematic efforts at compiling cross-country data at the ILO revealed the extent of the informal sector. Contrary to prior beliefs, legitimate activities in the informal sector accounted for as much as 20 per cent of gross domestic product (GDP) in developed economies (See Table 1) and well over 50 per cent of employment in developing economies.

The institutionalist school (Feige, 1990, McCaig and Pavcnik, 2015) attributes the high levels of informality to poorly functioning institutions that inhibited investments and establishment of business, and, in general, created an adverse environment for entrepreneurs. Developing

economies were caught in a vicious cycle of low growth rates and widespread unemployment and underemployment until governments established credible sustainable institutions.

Developments since the 1980s have raised questions about the institutionalist view. Since the 1990s, a number of developing and transitional economies, including China, India and Vietnam, have achieved high growth rates through reforms that broadly create the conditions to attract long term foreign and domestic investment, but with institutions that are far from ideal.

By the 1980s, attention shifted to include developments in the advanced economies of Western Europe and North America. The successive General Agreement on Tariffs and Trade and then the World Trade Organization trade liberalisation talks, and the universal trend towards deregulation triggered increased movement of capital and investment across national boundaries. To optimise costs, large firms, helped by falling transportation costs and improving information flows, spread the value chain across countries. Production was gradually restructured into smaller, flexible decentralised units. Labour entered into fixed, often short-term contracts, with compensation tied to hourly or piece rates.

In developing economies, in order to reduce costs, firms started hiring workers on short-term contracts at lower costs. Workers competing for a limited number of jobs had no choice but to enter short-term contracts. Without the social and other benefits accruing from long-term contracts, workers were *de facto* entering the informal sector.

Studies of the crises in Latin America, starting with Chile in 1979, and subsequently spreading to the rest of the Southern cone of Latin America – Argentina and Uruguay, followed by the East Asian crisis in 1997 (Feridhanusetyawan and Gaduh, 2000) – showed a sharp rise in informal sector activities, particularly the growth of tiny businesses and informal sector work (OECD, 2009; Loayza, N and C Rigolini, 2010). However, workers employed in small enterprises in the informal economy are also among the most vulnerable to layoffs during an economic downturn. Increasing unemployment was matched by a growth in the informal economy. The collapse of the Soviet Union in 1991 and liberalisation in Central and Eastern Europe led to sharp retrenchment in state enterprises and a corresponding increase in informal employment as workers and managers sought avenues to supplement earnings or start small businesses. The informal sector is not just an integral part of the landscape; it has

been growing over time. These developments raise important questions about the effects of the informal economy on broader economic performance.

Participants in the Informal Sector

Artisans in Mandalay, street vendors in Bogota and Bangkok, street side barbers in Mexico City, garbage collectors in Chandigarh, kielbasa and hotdog stand vendors in New York City, fabric patchwork artefact sellers in Lima, farmers selling fresh produce on the outskirts of Geneva, flea markets in Manchester, street stalls in St Petersburg, plumbers in Krakow, motor mechanics in Durban, street performers in Roppongi Hills, Tokyo – these are but some of the visible examples of informal markets. Less visible are domestic workers, among who is a preponderance of women, (WIEGO, 2014) in garment factories and as freelance consultants.

The informal sector is extremely diverse. It includes workers who are unable to find jobs in the formal sector and those engaged in part-time work. Street markets, small and tiny businesses, household enterprises, undocumented workers in the household sector, in the construction, in manufacturing and in agriculture and ancillary activities are all part of the highly varied informal sector. There are others who elect to be in the informal sector for the flexibility it offers, for example, programmers choosing to do part-time work, women who can only do part-time work as they do not have access to child care facilities.

The informal sector is characterised by easy entry and exit, small scale of operation, few employees and inability to access services in the formal sector, including finance, power and water supply. This keeps down the level of capital invested. As a result, informal enterprises generally use older cheaper technologies in the production of goods and services.

Working conditions vary significantly across informal sector workers, between those who sift through city garbage dumps salvaging plastic and metals, and sub-contracted workers in handicrafts and the garments sector, between street vendors and software programmers, and between domestic help and those on contracts in the security industry. While the informal sector reflects a segmentation of the labour market within particular sectors, employment terms can differ across states in a country and across firms in the same sector. Women tend to

be paid less for the same work, as do those in socially marginalised groups. Nearly all workers in the informal sector lack legal employment protection and, often, physical security in activities such as mining, fisheries, small chemical or metallurgical establishments.

Why does the Informal Sector Matter?

Contrary to perceptions, the informal sector is not a renegade economy. Goods and services produced by the informal economy are legitimate, though beyond the pale of regulatory purview. The informal economy is an integral part of the market economy. It is directly affected by regulation, globalisation and developments in national and global markets.

A slang term originating from Francophone Africa evocatively characterises the informal economy as ‘System D’, short for ‘*Système débrouillard*’ (Neuwirth, 2011). ‘System D’ alludes to resourcefulness and ingenuity, the ability to respond quickly to challenges, and adapt and improvise when necessary to complete the task at hand. It is a mind-set that Neuwirth (2011) believes exemplifies the ability of small entrepreneurs and workers in the informal economy to survive and often thrive in difficult environments. Neuwirth attributed the growth of the informal economy to cumbersome, expensive and inflexible requirements in the formal sector, a viewpoint endorsed by Hernando de Soto (de Soto, 2000). De Soto emphasises the importance of clear property rights in unlocking capital that is otherwise laid waste in emerging and transitional economies.

Webb et al. (2009) contend that weak enforcement of formal laws and regulations creates the opportunities for entrepreneurs in the informal economy. Boundaries between formal and informal institutions are constantly shifting with changes in regulation, contractual relationships, technology (freelance data processing and programming) and socio-cultural norms (desire for flexibility in work place).

The informal sector matters for its sheer size, pervasiveness in the economy, cross-border linkages and the substantial impact it can have on income, poverty and growth prospects in the economy.

Table 1: International Comparisons – Employment in the Informal Sector (Non-agricultural)

Country (Year)	Persons in Informal Employment		Persons employed in informal sector		Persons in informal employment outside informal sector	
	Thousands	%	Thousands	%	Thousands	%
Brazil (2009)	32,493	42.2	18,688	24.3	13,862	18.0
China* (2010)	36,030	32.6	24,220	21.9	13,850	12.5
India (2009/2010)	185,876	83.6	150,113	67.5	37,409	16.8
Indonesia (2009)	3,157	72.5	2,621	60.2	532	12.2
Mexico (2009 Q2)	20,528	53.7	12,861	34.1	7,620	20.2
Pakistan (2009/2010)	21,913	78.4	20,416	73.0	2,319	8.3
South Africa (2010)	4,089	32.7	2,225	17.8	1,864	14.9
Thailand (2010)	9,642	42.3	N.A.	N.A.	N.A.	N.A.

Source: ILO, 2012

Size

Estimating the size of the informal economy is a challenging task, especially as the *raison d'être* for informality is often the need to avoid detection or a conscious deliberate choice to avoid constraints imposed by ‘formality’. Policymakers also lack the incentives and capacity to measure and monitor the informal economy as these activities are beyond the reach of the tax authorities. Researchers use a number of indirect approaches to measure the informal sector, including labour market trends, unaccounted consumption of electricity, and in developed economies – extrapolating the excess demand for cash.

Neuwirth (2011) estimates the size of the global informal economy to be US\$10 trillion (\$\$13.6 trillion), which makes it larger than China’s economy and second only to the United States (US). The Organisation for Economic Co-operation and Development [OECD] (2009) believes that half the world’s workforce, 1.8 billion is employed in the informal economy. By 2020, the OECD predicts that nearly two-third of the global workforce will be employed in the informal economy. Contrary to theoretical predictions, the informal economy is here to stay and is expected to grow in the near future (Neuwirth, 2011; WIEGO 2014).

The extent of ‘informality’ differs widely across countries. Informal sectors are much bigger in developing economies. However, even in developed OECD (OECD, 2009) states, the informal economy accounts for 10 to 25 per cent of the workforce (Table 1). It is not only

large, but contrary to theoretical projections, the informal sector is also growing in unanticipated sectors, such as data processing, information technology (IT) services and coding, and activities such as piece manufacturing and garments in developing economies. In the endeavour to reduce costs, large manufacturing firms outsource the different stages of production. The trend towards using contract labour and, thereby, reducing the permanent labour force is fuelling a secular increase in the number of informally employed, especially down the value chain in developing economies. Vanek, et al (2012) points out that over 90 per cent of the labour force in India is in the informal sector. Schneider (2005) estimates that 40 to 60 per cent of the GDP in developing economies is produced in the informal sector.

Employment

A majority of the labour force in developing economies is employed in the informal sector. Outside the agriculture sector, 83 per cent of the labour force outside agriculture in India, 73 per cent in Indonesia, 43 per cent in Brazil, 33 per cent in South Africa is employed in the informal sector. Nearly 100 per cent of employment in agriculture in developing economies is without formal contracts, often on daily wages, seasonal employment or sharecropping practices (ILO, 2012).

In urban areas, most of the retail trade is reflected in small mom and pop, street side stores, shacks or simply off a sheet on the ground. The construction sector is a major employer, especially of migrant labour. So what kind of jobs will predominate? Part-time work includes a variety of self-employment schemes, consulting, moonlighting and unreported work after hours.

Workers on wage employment in the informal sector are vulnerable to abuse in many forms and dangerous working conditions. They are often underpaid, subject to delayed wages, arbitrary pay cuts and generally do not receive any benefits.

Impact on Women, Poverty and Inequality

Recent research highlights close links between informality and poverty, inequality and gender equity (WIEGO, 2014; Chen, 2012, Chen et al, 2004). A large proportion of women work informally for reasons ranging from gender bias in formal markets and the need for flexibility

in working hours to the type of activity they participate in – cooked food, domestic services and contract work that can be carried out from home. Informal sector activities are a major source of earnings for the poor, especially women who are either marginalised from the labour force or unable to work full-time due to family commitments. A number of activities that women are engaged in fall beyond the pale of formal activities. Chen et al. (2004, 2005) show that there is a preponderance of women in the more-economically vulnerable forms of informal employment, including domestic work, part-time piece work on garments or related activities, agricultural labour, small-scale entertainment, and hospitality and tiny businesses. Support for poor working women in these sectors is an important channel to reduce poverty and gender inequality. In developing economies where women are marginalised in the labour force, informal employment has been empowering (Dudwick, 2012; Kabeer and Kabir (2009), enhancing decision-making power in the household and prospects for gainful employment.

In Thailand and Indonesia, the informal sector grew significantly during the Asian Financial Crisis of 1997-98 as those retrenched from the industry turned to small informal businesses, including street vending to make ends meet (UN-Habitat, 2006). Likewise, during the 2007-08 global financial crisis and the subsequent economic crises in Greece, Portugal and Ireland, informal sector activities, ranging from home cooking and participation in flea markets to providing household services, rose as households sought to cope with income losses. Economic downturns are almost always accompanied by a rise in informal sector activities, as those laid off or suffering from a loss in income turn to part-time work or start a small business to make up for the financial loss. Loayza and Raddatz (2006) show that the participation in the informal sector has helped keep the participants above the poverty level and, in many cases, muster resources that otherwise could not have been deployed productively.

The digital divide is considered to have reinforced income inequality. However, some recent initiatives have been of immense benefit to the poor (World Bank, 2016). The digital divide itself is being blurred through successful initiatives such as Vodafone's M-Pesa initiative in Kenya that has brought payment services and associated banking services to a large segment of the Kenyan population which had never been able to access formal financial services earlier. Telecommunication operators and other institutions are providing similar services in

many other countries. Health, weather information and information on current market prices are helping the poor utilise resources more effectively and also manage risks.

The urban informal sector in developing Asian and African economies is growing with the migration from the countryside. The informal sector provides a useful avenue for gainful employment. The urban informal economy offers commerce and economic opportunity to those invisible to policymakers. In some cases, small businesses and service providers are providing services that fill missing markets (UN-Habitat, 2006; Kusakabe 2006). Urban slums are providing their own services for waste clearance, transportation, waste recycling and even utility provision. ‘System D’ steps in where the governments are missing (IMF, Singh et al. 2012), and corrects for government failure as well. At a time when jobs are hard to come by and employment prospects across the globe remain bleak, the informal sector offers a vital lifeline to hundreds of millions of workers in developing and, increasingly, in developed economies as well.

Impact on Productivity and Growth

The biggest drawback of ‘informality’ is embedded in the definition of the sector. Informal enterprises are unable to obtain finance from formal sources or benefit from government programmes and basic utilities such as power and water supply. Small informal manufacturing enterprises are less productive than their cohorts in the formal sector (Bloom et al, 2010). However, contrary to intuition, larger informal sector enterprises are found to be less efficient than smaller ones. Interestingly, larger informal firms have been found to be less efficient than their smaller counterparts (Amin and Islam, 2015). This may well be due to the loss of advantage of ‘formality’ as the firm grows, and finance and other constraints become more cumbersome. It may also suggest that small informal firms see themselves as subsistence entities and do not have the incentive or wherewithal to grow. In such instances, endeavours on the part of policymakers to ‘formalise’ these institutions may be counterproductive. The relative inefficiency of small informal sector firms, relative to their cohorts in the formal sector, is well documented (Hasan et al. 2012).

Globalisation

As mentioned earlier, since the 1980s, a growing number of firms in the developed countries have subcontracted production out to firms in the developing economies (Henderson et al, 2001). These firms, in turn, hire workers on temporary or even daily contracts to further keep labour costs down and avoid dealing with unionised labour. There is a further segmentation of labour markets between a core quasi-permanent workforce and seasonal and daily labour. The consequences of globalisation permeate all sectors of the economy. A disaggregation of the firm has resulted in the growth of the informal workforce, especially in sectors such as the manufacture of athletic footwear, ready-made garments, sea-food processing.

The fall in commodity prices since the 2015 has directly impacted the entire value chain – from scrap dealers in Bangladesh, Nigeria, India and many other developing economies to the desperately poor scavenging through rubbish heaps for bits of metal.

Incidents of terrorism in Turkey, Bali, Egypt and elsewhere directly impact the entire range of services – from small restaurants and private garbage collectors to laundry services and many others drawing upon tourist and business traffic for a living.

During economic downturns, such as the global financial crisis of 2007-08, countries impacted by the recession observed a rise in informal sector activities as people try to cope with uncertainty and the loss of income by turning to small businesses or activities that could be carried out from home with minimum capital. The informal sector provides a form of implicit insurance during challenging times by allowing households to augment earnings from the formal sector with informal earnings.

China's informal trade with the rest of the world is perhaps almost as visible as its formal trade (Allen et al 2002). Small and large traders, businessmen and trading houses buy from manufacturers in China for sale in their home countries or third countries. Much of this trade is visible in countries bordering China and has developed its own supply chains that may end up with street vendors in third world countries. China's manufacturers have been willing to trade with the informal sector or 'System D' and are now integral to regional and global value chains.

Informal enterprises have also served as a fountainhead for innovation in the small-goods sector. They offer a low cost option for small entrepreneurs seeking to test out an idea or an incubator for businesses ranging from boutique to indigenous mechanical appliances.

Links with the Formal Sector

Informal enterprises do not function in a vacuum. They are directly impacted by policy changes. Changes in the macroeconomic environment, be it growth, inflation, a slowing economy or a monetary policy change, directly impact informal enterprises. Informal enterprises are directly embedded in the value chain, for example, in the garment industry, handicrafts or manufacture of many consumer goods. Informal enterprises supply to and source for the formal sector for goods. For example, significant changes in the price of fish or rice will directly impact hawker centre vendors in Singapore and Malaysia. These enterprises may have to buy electricity and water supply from the city government, and they are often engaged in small catering contracts to local offices. Scrap metal dealers may be at one end of the value chain for large metallurgical enterprises. The links with the formal sector are constantly changing and evolving with changes in regulatory structures and economic conditions (Guha-Khasnobis, 2006, Banerjee and Duflo, 2011). Despite the tenuous economic prospects and seemingly endemic uncertainty, why do individuals and firms choose to enter and stay in the informal sector?

Why do Firms and Individuals opt for the Informal Sector?

The *raison d'être* is often no different from any situation where agents do not have choices. Informality may be the only option for millions lacking the skills or education to enter the formal labour force. Informal sector activities are not always carried out with the intent of evading regulatory scrutiny or evading tax liabilities. For firms and workers, the choice is likely to be dictated by a personal or enterprise-level cost-benefit analysis of staying informal or registering a business.

Firms

The activities of the firms in the informal sector are, per se, not illegal, but they do lie outside the purview of regulatory scrutiny. The economic motivation includes the ability to evade taxes, avoid costly regulatory licensing requirements (Loayza, 1997) and have the flexibility with which informal enterprises can function. The monetary and psychological benefits (of operating independently) may turn the decision in favour of informal enterprise.

Studies by the World Bank on the 'Ease of Doing Business' and 'Enterprise Surveys' reveal how the cost of doing business, that is, high business registration costs, cumbersome regulations, can deter small entrepreneurs. Restaurateurs may need permission from multiple government departments, each of which, if not administered fairly, transparently and expeditiously, could inhibit the business-owner from attempting to 'formalise'. Each of these departments can withhold permission almost indefinitely, adding uncertainty and capital costs to the process. In the construction sector, mining and fisheries, an overwhelming majority of workers employed informally on short-term contracts, work in hazardous conditions, are underpaid and lack basic employment protection. This reflects a failure on the part of the state to ensure basic safety conditions are observed. Cumbersome regulations create a fertile ground for corruption – a major deterrent for entrepreneurs.

Workers

For workers, there may often not be a choice (WIEGO, 2012). The paucity of jobs in the formal sector drives many workers to seek opportunities in the informal sector. Workers in informal manufacturing enterprises, mining, agriculture or fisheries are driven to these jobs for want of choice. Given a choice, most workers in the informal sector would prefer a formal job with the social protection and certainty of employment, wages and benefits it provides. The decision to remain informal or hire labour on temporary contracts is made by the owners of capital and the employers.

Conversely, some workers believe they can earn more through informal sector work than at a formal job, for example, starting a small business. Work in the informal sector may offer more flexibility and independence. This may especially be the case for women with little

education and lower skills than men, and who also bear the responsibility for child care and running the household.

Taxes

Research shows a close correlation between tax rates in developing economies and the size of the informal sector. High taxes dissuade firms from registering their business. This is true of developing economies in particular (Loayza, 1997). Conversely high tax rates in developed economies, for example, Sweden, Norway and Denmark, result in better provision of public goods, a broader safety net and higher expenditure on infrastructure that will help nurture enterprise. The underground sector in these economies is much smaller than other OECD economies (Schneider et al, 2010).

Weak Institutions

Weak regulatory institutions, resulting in high contractual costs, longer procedures for settling contracts, an inefficient or corrupt administrative, judicial and police force, will push more businesses into the informal sector. Data shows a strong inverse correlation between the efficiency of institutions which directly impact of the cost of doing business and the size of the informal sector (Smith 1994, de Andrade et al 2013, Rothenberg, 2016).

Labour Market Restrictions

Stringent labour market regulations have the unintended consequence of encouraging informal labour arrangements because they raise the cost of hiring for firms. Restrictions on hiring and firing intended to protect workers have instead discouraged firms from hiring in the formal labour market because compliance tends to be expensive and cumbersome. Instead, firms hire informal workers, pay them under the table and avoid providing health insurance and other benefits. Studies by the OECD (2013) show that developing countries often have more stringent labour regulations than the developed OECD economies.

The size of the firm is an important consideration in inducing firms to remain informal. The majority of informal firms in developing economies have a workforce that is below 10 persons. Crossing that threshold results in an automatic application of labour regulations, that

though intended to protect worker's interests, wind up substantially raising the cost of hiring labour and making it difficult to retrench labour during a downturn.

The Costs of Informality

Firms operating in the informal sector face a variety of constraints that make it difficult for them to do business and grow. These include access to infrastructure, electricity, land and water. To avoid penalties and detection, informal enterprises constantly remain in an environment of uncertainty. The workplaces have to be less visible. They also cannot enter contracts where documentation is required or advertise their business. Informal enterprises cannot scale up operations or buy out other businesses, though in settings where informality is pervasive, entrepreneurs do find ways around these obstacles, at a price. Access to formal finance is arguably one of the biggest hurdles. The expansion of informal financial networks helps to mitigate this to an extent, though the costs of informal finance tend to be significantly higher than the cost of borrowing through formal channels. There are restrictions on the transfer of property, titles to business, lack of insurance and the absence of any intellectual property protection. The denial of property rights severely handicaps informal enterprises in their dealings with formal institutions, and long-term planning.

How does Regulation Impact the Informal Economy?

Over Regulation

One of the main causes of the rise of informality is excessive and inefficient government intervention in economic activity. Research at WIEGO (2012) suggests that over-regulation raises transaction costs, and barriers to entry to the formal sector as well as to informal sector operations. Onerous labour regulation raises the cost of going formal and induces firms to remain small, below the threshold where the number of employees would result in strict labour regulation coming into effect. This phenomenon is observed in many countries, including advanced OECD economies, for example, in France, stricter regulations come into

effect when the firm size exceeds 49 employees. The effects of this restriction are reflected in the large proportion of firms that fall just below this threshold.

The World Bank's 'Ease of Doing Business' and 'Enterprise Surveys' provide estimates of the regulatory burden imposed by regulations governing business. These include the gamut from initial registration of the company to obtaining the necessary permits and land acquisition. Countries imposing high costs on business have larger informal sectors. Entrepreneurs in such economies, especially small- and medium-sized enterprises find informality a value-enhancing proposition.

Absence of Regulation

The growth of cities in developing economies, especially those in Asia, is largely fuelled by economic growth and immigration from the countryside. However, city masterplans almost never have a plan for migrant housing or basic facilities such as markets for this growing community. The growth of slums and street markets is an inevitable consequence of this neglect. Street markets in many cities have, in turn, evolved into vibrant cultural and culinary areas, valued by locals, visitors and tourists alike. Street markets create a distinct urban ecosystem that helps fill missing markets. However, in the absence of a regulatory framework, or even recognition of their existence, they remain at the mercy of officials, often subject to arbitrary actions.

The internet economy reflects the rapid rise of a sector that did not exist even in the public imagination two decades ago. The minimal regulation has often helped fuel creativity and growth. The rise of the IT sector in India is attributed by some to the absence of an earlier regulatory framework that has impeded investment in many other traditional sectors.

Deregulation

Labour markets are caught between two binary ends – excessive regulation and deregulation. Deregulation has imparted flexibility to labour markets, resulting in the rise of contractual labour as a new form of labour contracts and shrinking permanent employment (ILO, 2015). Combined with increasing restrictions on mobility of labour across national boundaries – the balance of power is skewed against wage labour in favour of the owners of capital. This may

well be one of the factors contributing to the growth of the informal sector workforce and the secular increase in inequality within economies (Chen et al. 2004).

Depending on the context, excessive regulation, the absence of regulation or deregulation can result in the growth of the workforce in the informal sector. Policymakers need to take a sectoral view to determine the appropriate type of regulation.

What may the Future Hold?

The prognosis for job creation in the global economy has been bleak for the past several years. Structural transformation, disaggregation of manufacturing, increasing automation and the use of capital intensive technologies are contributing to a low rate of job creation and a shift to value creation in the informal sector (Burger et al, 2015; OECD 2009).

Disaggregation of manufacturing, for example, in the automobile industry, began in the 1980s. Coupled with the increased use of robots, this has reduced the demand for labour in the major automobile firms. In jurisdictions with limited labour protection, in an effort to reduce costs, firms across the world hire workers on fixed short-term contracts. This enables firms to evade the costs of employee benefits as well as pension schemes. For workers, the only recourse to employment may be seasonal contracts lacking social benefits. This is a widespread practice in many developing economies (ILO, 2015) that will not change without economic growth and increased efficiency of institutions. Such a scenario would provide conditions for revisions in labour laws and broader agreements between labour and management.

There is a need for a clearer understanding of the effects of decentralisation of production decisions, the shift to short-term contracts and, indeed, the power relationship between the owners of capital and the owners of labour, and the sort of contractual arrangements that would lead to the highest social benefits. To do this in a meaningful manner, policymakers need to be in a position to assess how initiatives work out into action at the grassroots (enterprise and worker) level.

The global economy may indeed be going through a paradigm change as the effects of deregulation and globalisation seem to result in structural changes in the relationship between the owners of labour and the owners of capital. In developed as well as developing economies, an incremental increase in output is leading to a lower rate of job creation. Few jobs are being created in the formal sector, and existing jobs in the formal sector are being pushed into the informal sector (ILO, 2015).

Much of the shift of contractual and part-time work nudges workers into the informal sector. For professionals it may offer much desired flexibility. For blue collar workers and those beyond the purview of the formal sector, it implies low wages, endemic uncertainty and an inability to plan for the future with a degree of confidence.

The developed world point is experiencing low rates of employment generation as against high growth rates in emerging markets, which is fostering a steady increase in the size of the informal sector. The employment elasticity of growth has been falling steadily over the past three decades. Contrary to prior beliefs, growth policies do impact the informal sector directly as do changes in regulations and market conditions. These factors are contributing to increasing inequality within economies – a phenomenon that could result in increasing social instability.

Creative policy interventions by government agencies and non-government organisations have been extremely successful. Interventions by Bangladesh's Grameen Bank in markets which official financial institutions would not enter, has been profoundly successful in changing life in rural areas and empowering women. This initiative has been repeated in many countries across the globe, to the point where private equity managers and venture funds are keen to enter the market. The Vodaphone experiment in Kenya resulted in one of the most rapid and remarkable expansions of e-payment systems ever seen. That has become a template for financial inclusion across the globe. M-Pesa has been widely adopted as an instrument to ease payments among the poor.

Policy Implications

The growth of the informal economy or ‘System D’ has posed fundamental challenges to the understanding of economics, business and governance. It exists beyond the purview of regulatory authorities, yet there is much that is positive in its contribution to alleviating abject poverty, mitigating unemployment, providing opportunities to women in settings where they are otherwise disenfranchised, and often serve as incubators for new businesses. Conversely, the growth of informality in manufacturing risks lowering the overall productivity, reducing competition and dampening growth prospects.

Policymakers generally hesitate to tread into areas where they cannot measure inputs and outcomes. The informal sector is bedevilled by such problems. However, rather than deny its existence, it may be time to think differently and accept the fact that the segment of the informal sector that engages in legal activities is here to stay. There is a pressing need for research on the ‘why’ and ‘how’ of informal sector activities. Extending basic protection to workers in informal sector enterprises would be a useful start in helping mitigate the most egregious violations of rights.

The task is challenging. The heterogeneous nature of the informal sector, and the varied causes underlying its growth in different economies, warrants a deeper and clearer understanding of the factors that lead to growth of the informal sector and a granular approach to policy formulation.

Informal sector participants in legal activities but not officially registered should not be seen as ‘rogue’ activities that need to be stamped out. Workers enter the informal sector for want of choice. But they make a real contribution to the wider economy as well as their immediate community.

Micro-entrepreneurs

In developing economies, micro-entrepreneurs and small scale businesses desist from registering their activities for a host of reasons. Tiny entrepreneurs that have mobile vending operations, for example, selling prepared food or fruit or vegetables or providing basic household services, are unlikely to have the capital and will be deterred by high registration

costs or regulations. There are instances of regulatory authorities adopting a proactive stance towards informal enterprises (Kusakabe, 2006). Research has shown that these vendors are self-regulated. Having repeat customers in the community compels them to maintain basic sanitary conditions and serve fare that appeals to their clientele. In the poorest parts of Southeast Asia, the odds of a tourist falling ill due to unhygienic food are higher in restaurants than street food vendors (evidence of this can be found in Lonely Planet guides and various travel blogs). This market segment needs a ‘light’ approach to regulation, ensuring basic zoning, timing and sanitary conditions.

Wage Employment

Workers employed as contract labour in large manufacturing enterprises have partial recourse to regulatory authorities, though limited to no collective bargaining power. The most vulnerable are the workers in ‘irregular’ enterprises, for example, in privately owned coal mines, quarries and construction. These workers, who sometimes have to queue up for jobs daily, face endemic uncertainty and have virtually no bargaining power. Without bringing these enterprises under the ambit of ‘formality’ there is a profound need for the state to step in to ensure minimum wages, safety and basic living conditions for the workers on site. Often, there are prescribed safety codes that apply throughout the economy but these are loosely imposed on informal sector employees.

Entrepreneurs

Entrepreneurs will formalise if they see the benefits of formalisation outweighing the benefits of staying informal. As a first step, regulatory barriers and red tape need to be rationalised and streamlined. Formalisation should be seen as a process and not a one-off step. Easing the conditions for doing business and reducing the costs of doing business, enhancing the attractiveness of registering businesses, improved monitoring of working conditions, are some of the first steps that would help lower the hurdle towards formalising. Micro-entrepreneurs who do not seek to expand business and are content with current conditions are perhaps best left alone – in a setting where their only demand is freedom from harassment by the authorities, and provision of basic public services, such as security of property rights, water and electricity.

Concluding Observations

In the aftermath of the global financial crisis of 2007-08, the share of informal employment in the labour force has increased significantly. Amongst the OECD states, this is particularly notable in Southern Europe – in Portugal, Spain, Greece and Italy, where there are few job openings. In Asia, the layoffs led to a significant increase in the workers in vulnerable informal employment (Huynh et al. 2010). Job creation has lagged behind growth, not only in developed states, but also in many developing economies. This may be an important factor behind the rise of economic nationalism, reflected in electoral outcomes in the US and the Brexit vote. However, the informal sector has not been immune to crises. With globalisation, the disaggregation of manufacturing and the rise of global supply chains, the links between the formal and informal sector are stronger than before. As a result, the informal economy has not remained immune to crises, though it continues to offer opportunities for part-time work as well as to tiny household business.

The rise of the ‘gig’ economy is lending a new dimension to informality. The rapid growth of aggregators such as Uber, Lyft, Didi Chuanxing, GrabTaxi, Ola and many other sharing apps across the world in the hospitality sector (AirBnB, Oyo) and food delivery services (UberEats, Food Panda, Deliveroo) has opened new opportunities for employment, albeit, thus far, without the protection afforded to the workers in the formal sector. Nevertheless, the flexibility offered has steadily increased the numbers to these new openings for gainful work.

The informal economy is a significant part of many countries’ economies and represents an important avenue for poverty alleviation and growth in developing countries. It also serves as an incubator for tomorrow’s growing businesses. However, large informal sectors in developing economies that gain root due to regulatory burdens lead to low productivity and low growth, impairing overall economic performance. Fostering inclusive growth requires an understanding of the incentives motivating informal activity, to bring as many people as possible into the formal economy. Studies at the ILO and the Women in Informal Employment: Globalizing and Organizing network offer some insights into constructive approaches for policymakers. Notable among these is the ILO’s gradualist approach of ‘transition to formality’. These approaches essentially entail strengthening property rights and the rule of the law, and eliminating arbitrary changes in policies towards the legitimate parts of the informal economy, reforms which should make formalisation an attractive proposition

(Rotherberg et al. 2016). There is increasing evidence that opening up the economy has a catalysing effect in expediting the transition to employment in the formal sector (McCaig and Pavcnik, 2015; La Porta and Shleifer 2014).

Dichotomising the formal and informal sector carries little meaning in today's world and can even lead to counter-productive outcomes. There is a profound need for governments to recognise that the informal sector is an integral thriving part of the economy, certainly in the medium term. Over the longer-run, with prosperity, as markets develop and regulatory abilities improve, the case for enterprises to formalise should acquire a rationale of its own.

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