The informal economy is seen as being problematic by many observers, not least because of its association with poverty and low productivity. However, there is little in the way of consensus on the diagnosis of the problem, let alone on policies to address it. Thus, for example, The Economist magazine in its survey of Latin America (September 9, 2010) concludes that:

“Thanks largely to baroque regulation, half the labour force toils in the informal economy, unable to reap the productivity gains that come from technology and greater scale.”

This view is held by many economists and policy analysts. But Chen and Doane (2008), in a review of informality in South Asia, argue instead that:

“Economic stagnation and labour market rigidities alone cannot explain the extent of informal employment.”

This view is held by many civil society activists and by non-economist analysts. It is the position taken by WIEGO (http://wiego.org). What explains such widely divergent assessments, and the policy conclusions that then follow? This brief note tries to understand such divergences in terms of a simple framework.

Let us begin by defining formality and informality of economic activity relative to a set of laws and regulations. For concreteness, think of laws or regulations which specify that for enterprises larger than 9 workers, it is mandatory to register for taxation, to make social security contributions, and to pay a minimum wage. Given the regulations, economic activity can be classified into four categories (Kanbur, 2009).

A. Activities that come under the purview of regulation, and comply. In our example, these would be enterprises with more than 9 workers who do indeed register for taxation, etc. This is the normal conceptualization of formality. By definition, everything else is informal. But there are at least three categories within the set of informal activities.

B. Activities that come under the purview of regulation but do not comply. This would be an enterprise that has more than 9 workers but is not registered, etc. This is straightforward evasion and illegality.

C. Activities that do not come under the purview of regulation, but only because they have adjusted out of the ambit of controls. An example of this is an enterprise that would have
employed 10 workers without the regulation, but is now employing only 8 workers so as to avoid the costs (net of benefits) of the regulations in question.

D. Activities that would not come under the purview of the regulation at all. In our example this would be an enterprise that employed 3 workers before the regulation, and continues to do so after.

Category B depends on the costs of the regulation but also on the effectiveness of enforcement. Category C depends on the relative costs and benefits of staying out of the ambit of the regulation—for our example, the diseconomies of operating at lower scale than would be optimal without the regulation. Category D, however, depends not on the regulations but on a range of constraints on enterprises from growing in size, for example, credit constraints or infrastructure impediments.

It is important to realize that although statistical measures of informality are mostly derived as the complement of A, in other words, as B+C+D, informality is in fact composed of three distinct categories, explained by different factors. Using terms that are by now standard, informality consists of evaders (B), avoiders (C), and outsiders (D). With this disaggregation, it should be clear that the focus of The Economist magazine is almost entirely on categories B and C, and the transition from A to these categories, whereas the focus of WIEGO is almost entirely on category D, which is disconnected from the regulations that influence the balance between A and B+C. Consider then the following policy question:

- If the objective is greatest sustainable impact on poverty, is the policy priority to use the limited financial, administrative and political resources to (i) raise productivity and incomes in D or (ii) reforming regulations to reduce adjustment out of A into B and C?

The answer to this question in turn depends on a series of other questions:

- How big is B+C relative to D? (Also, how big is B relative to C?)
- What exactly is the impact of specific laws and regulations on the size of B and C relative to A?
- How do changes in technology and global trading conditions shift the balance between B, C and A?
- What are the productivity differences between B + C and A?
- What are the productivity differences between D and B + C?
- What can increase productivity in D?

The Economist magazine’s implied policy thrust is valid when (i) B+C is large relative to D, (ii) the impact of regulations on adjustment out of A is large, (iii) globalization and technical change increase the impact of regulations on adjustment out of A and (iv) productivity losses from adjusting out of A into B+C are
large. The WIEGO policy thrust has validity when (i) –(iv) do not hold and in addition incomes in D are much lower than in B+C, leading a pro-poor policy to focus on the outsiders more than on evaders and avoiders.

However, empirical analysis of informality does not systematically and as a matter of routine disaggregate the informal sector between B, C and D, so we do not have estimates of the relative sizes of the relevant categories, nor do we have significant and sustained evidence on the impact of policies on the categories taken separately. Rather, what we have are estimates for B+C+D, and these estimates are interpreted as applying to B+C by one group of analysts and advocates, and as applying to D by another group of analysts and advocates. There are of course exceptions, but this would perhaps be a fair description of the state of play.

What is needed in achieving consensus on policy towards informality therefore, are answers to the questions posed above. The simple framework presented here may serve to clarify the nature of disagreements in diagnosis and prescription, pointing to empirical analysis that can help to resolve often radically opposed perspectives.

References


