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## **Rethinking the Informal Economy: Linkages with the Formal Economy and the Formal Regulatory Environment**

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### **Abstract**

This paper explores the relationship of the informal economy to the formal economy and the formal regulatory environment. It begins with a discussion of the concept of the informal economy and its size, composition, and segmentation. It then discusses the linkages between the informal economy and the formal economy and the formal regulatory environment. The conclusion suggests why and how more equitable linkages between the informal economy and the formal economy should be promoted through an appropriate inclusive policy and regulatory environment.

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# Rethinking the Informal Economy: Linkages with the Formal Economy and the Formal Regulatory Environment

*Martha Alter Chen*

Since it was ‘discovered’ in Africa in the early 1970s, the informal economy has been subject to interpretation and debate and has gone in and out of fashion in international development circles. Despite the debates and critiques, the informal economy has continued to prove a useful concept to many policymakers, activists, and researchers because the reality it captures—the large share of economic units and workers that remain outside the world of regulated economic activities and protected employment relationships—is so large and significant. Today there is renewed interest in the informal economy worldwide. This re-convergence of interest stems from two basic facts. First, despite predictions of its eventual demise, the informal economy has not only grown in many countries but also emerged in new guises and unexpected places. Second, despite continuing debates about its defining features, supporting informal enterprises and improving informal jobs are increasingly recognized as key pathways to promoting growth and reducing poverty.

This paper explores the relationship of the informal economy to the formal economy and the formal regulatory environment. It begins with a comparison of the earlier concept of the ‘informal sector’ with a new expanded concept of the ‘informal economy’ and a discussion of the size, composition, and segmentation of the informal economy broadly defined. The second section discusses the linkages between the informal economy and the formal economy, on one hand, and the formal regulatory environment, on the other. The concluding section suggests why and how more equitable linkages between the informal economy and the formal economy should be promoted through an appropriate policy and regulatory environment.

## **The informal economy**

The recent re-convergence of interest in the informal economy has been accompanied by significant rethinking of the concept, at least in some circles. The rethinking about the informal economy, summarized below, includes a new term and expanded definition; recognition of its segmented structure; and a revised set of assumptions about its defining features. This section concludes with a summary of available statistics on women and men in the informal economy broadly defined.

### ***New Term and Expanded Definition***

In recent years, a group of informed activists and researchers, including members of the global research policy network Women in Informal Employment: Globalizing and Organizing (WIEGO), have worked with the International Labour Organization (ILO) to broaden the earlier concept and definition of the ‘informal sector’ to incorporate certain types of informal employment that were not included in the earlier concept and definition (including the official international statistical definition). They seek to include the whole of informality, as it is manifested in industrialized, transition and developing economies and the real world dynamics in labour markets today, particularly the employment arrangements of the working poor. These observers want to extend the focus to include not only *enterprises* that are not legally regulated but also *employment relationships* that are not legally regulated or protected. In brief, the new definition of the ‘informal economy’ focuses on the nature of employment in addition to the characteristics of enterprises. It also includes informal employment both within and outside agriculture.

Under this new definition, the informal economy is comprised of all forms of ‘informal employment’—that is, employment without labour or social protection—both inside and outside informal enterprises, including both self-employment in small unregistered enterprises and wage employment in unprotected jobs.

### ***Key Features of the Informal Economy***

What follows is a discussion of key features of the informal economy broadly defined, including: its significance and permanence, the continuum of employment relations within it and its segmented structure. The discussion ends on the issue of its legality or illegality as there is a widespread misconception that the informal economy is somehow illegal or is the equivalent of the underground, or even criminal, economy.

*Significance and permanence:* The recent re-convergence of interest in the informal economy stems from the recognition that the informal economy is growing; is a permanent, not a short-term, phenomenon; and is a feature of modern capitalist development, not just traditional economies, associated with both growth and global integration. For these reasons, the informal economy should be viewed not as a marginal or peripheral sector but as a basic component—the base, if you will—of the total economy.

*Continuum of economic relations:* Economic relations—of production, distribution and employment—tend to fall at some point on a continuum between pure ‘formal’ relations (i.e., regulated and protected) at one pole and pure ‘informal’ relations (i.e., unregulated and unprotected) at the other, with many categories in between. Depending on their circumstances, workers and units are known to move with varying ease and speed along the continuum and/or to operate simultaneously at different points on the continuum. Consider, for example, the self-employed garment maker who supplements her earnings by stitching clothes under a sub-contract, or shifts to working on a sub-contract for a firm when her customers decide they prefer ready-made garments rather than tailor-made ones. Or consider the public sector employee who has an informal job on the side.

Moreover, the formal and the informal ends of the economic continuum are often dynamically linked. For instance, many informal enterprises have production or distribution relations with formal enterprises, supplying inputs, finished goods or services either through direct transactions or sub-contracting arrangements. Also, many formal enterprises hire wage workers under informal employment relations. For example, many part-time workers, temporary workers and homeworkers work for formal enterprises through contracting or sub-contracting arrangements.

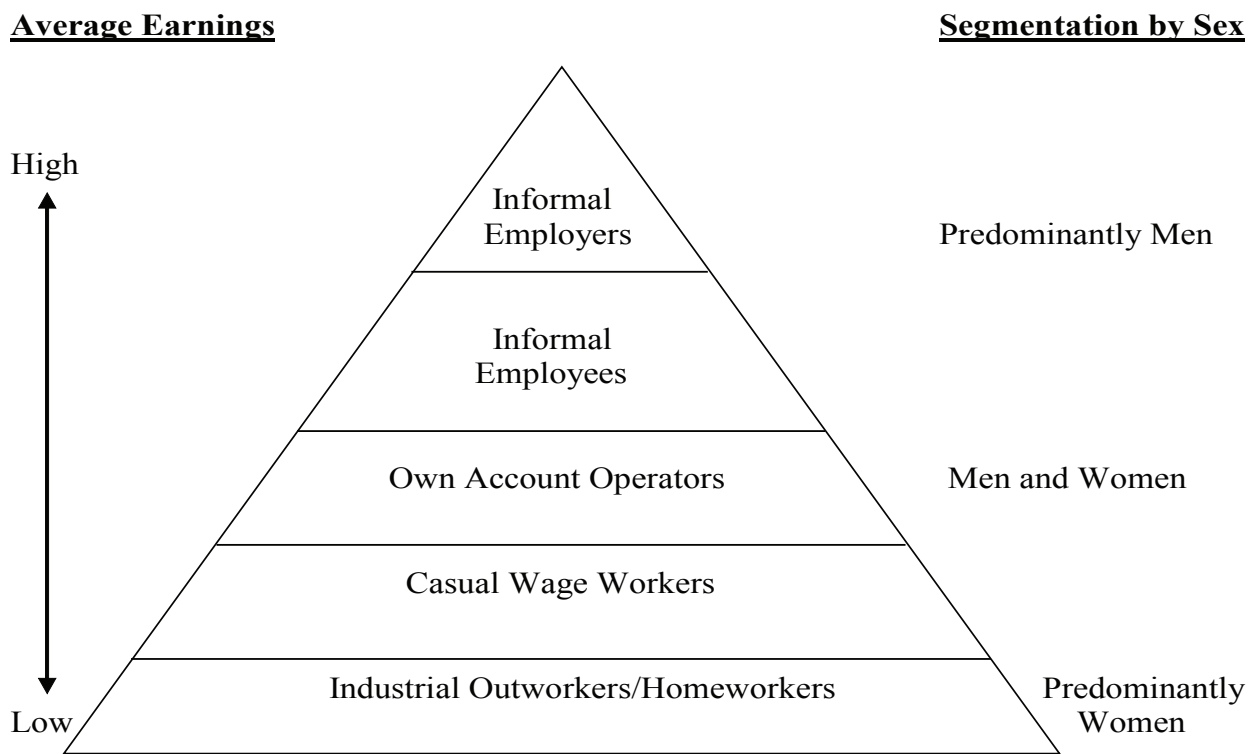
*Segmentation:* The informal economy consists of a range of informal enterprises and informal jobs. Yet there are meaningful ways to classify its various segments, as follows:

- *Self-employment in informal enterprises:* workers in small unregistered or unincorporated enterprises, including:
  - o employers
  - o own account operators: both heads of family enterprises and single person operators
  - o unpaid family workers
- *Wage employment in informal jobs:* workers without worker benefits or social protection who work for formal or informal firms, for households or with no fixed employer, including:
  - o employees of informal enterprises

- o other informal wage workers such as:
  - ◇ casual or day labourers
  - ◇ domestic workers
  - ◇ unregistered or undeclared workers
  - ◇ some temporary or part-time workers<sup>1</sup>
- o industrial outworkers (also called homeworkers).

From recent research findings and official data, two stylized global facts emerge about the segmented informal economy. The first fact is that there are significant gaps in earnings within the informal economy: on average, employers have the highest earnings; followed by their employees and other more “regular” informal wage workers; own account operators; “casual” informal wage workers; and industrial outworkers. The second is that, around the world, men tend to be over-represented in the top segment; women tend to be over-represented in the bottom segments; and the shares of men and women in the intermediate segments tend to vary across sectors and countries. These twin facts are depicted graphically in Figure 1.

Figure 1.  
Segmentation of the informal economy



Note: The informal economy may also be segmented by race, ethnicity, caste, or religion.

The net result is a significant gender gap in earnings within the informal economy, with women earning less on average than men.<sup>2</sup> An additional fact, not captured in Figure 1, is that there is further segmentation and earning gaps within these broad status categories. Women tend to work in different types

1 Those temporary and part-time workers who are covered by labour legislation and statutory social protection benefits are *not* included in the informal economy.  
 2 For a detailed analysis of available statistics on the gender segmentation of the informal economy and the linkages between working in the informal economy, being a woman or man, and being poor, see Chen and others (2004).

of activities, associated with different levels of earning, than men—with the result that they typically earn less even within specific segments of the informal economy. Some of this difference can be explained by the fact that men tend to embody more human capital due to educational discrimination against girls, especially in certain societies (e.g., in North India and Pakistan). This difference can also be explained by the fact that men tend to have *better tools* of the trade, operate from *better work sites/spaces* and have *greater access to productive assets and financial capital*. In addition, or as a result, men often produce or sell a *higher volume* or a *different range* of goods and services. For instance, among street vendors in some countries, men are more likely to sell non-perishables while women are more likely to sell perishable goods (such as fruits and vegetables). In addition, men are more likely to sell from push-carts or bicycles while women are more likely to sell from baskets, or simply from a cloth spread on the ground.

#### *Legality or Semi-Legality*

Previously, there was a widespread assumption that the informal sector was comprised of unregistered and unregulated enterprises whose owner operators choose to avoid registration and, thereby, taxation. While it is important to understand informal employment in relation to the legal framework in any given country, this is far from being the whole story.

- There is a distinction between illegal *processes or arrangements* and illegal *goods and services*. While production or employment arrangements in the informal economy are often semi-legal or illegal, most informal workers and enterprises produce and/or distribute legal goods and services. Admittedly, one part of the informal economy—the criminal economy—operates illegally and deals in illegal goods and services. But it is only a small part of a larger whole that is, for the most part, not illegal or criminal.
- Many owner operators of informal enterprises operate semi-legally or illegally because the regulatory environment is too punitive, too cumbersome or simply non-existent. Also, many informal activities do not generate enough output, employment or income to fall into existing tax brackets.
- Most owner operators would be willing to pay registration fees and taxes if they were to receive the benefits of formality (enjoyed by registered businesses). For instance, street vendors who now pay a mix of legal and illegal fees would welcome the security that comes with being legally recognized (Chen, Vanek and Carr, 2004; Chen and others, 2005).
- It is important to note that, in the case of informal wage work, it is usually not the workers but their employers, whether in formal or informal firms, who are avoiding registration and taxation.

More fundamentally, most informal workers associate operating outside the legal regulatory framework with costs rather than benefits. Most self-employed and wage workers in the informal economy are deprived of secure work, worker's benefits, social protection and representation or voice. The self-employed must take care of themselves and their enterprises as well as their employees (if they hire others) or unpaid contributing family members (if they run a family business). Moreover, they often face competitive disadvantage vis-à-vis larger formal firms in capital and product markets. Informal wage workers also have to take care of themselves as they receive few (if any) employer-sponsored benefits. In addition, both groups receive little (if any) legal protection through their work or from their governments. As a result of these and other factors, a higher proportion of the informal workforce than of the formal workforce is poor.

Table 1 summarizes the key differences between the old and new views of the informal economy.

Table 1.  
Old and new views of the informal economy

<i>The old view</i>	<i>The new view</i>
The informal sector is the traditional economy that will wither away and die with modern, industrial growth.	The informal economy is 'here to stay' and expanding with modern, industrial growth.
It is only marginally productive.	It is a major provider of employment, goods and services for lower-income groups. It contributes a significant share of GDP.
It exists separately from the formal economy.	It is linked to the formal economy—it produces for, trades with, distributes for and provides services to the formal economy.
It represents a reserve pool of surplus labour.	Much of the recent rise in informal employment is due to the decline in formal employment or to the informalisation of previously formal employment relationships.
It is comprised mostly of street traders and very small-scale producers.	It is made up of a wide range of informal occupations—both 'resilient old forms' such as casual day labour in construction and agriculture as well as 'emerging new ones' such as temporary and part-time jobs plus homework for high tech industries.
Most of those in the sector are entrepreneurs who run illegal and unregistered enterprises in order to avoid regulation and taxation.	It is made up of non-standard wage workers as well as entrepreneurs and self-employed persons producing legal goods and services, albeit through irregular or unregulated means. Most entrepreneurs and the self-employed are amenable to, and would welcome, efforts to reduce barriers to registration and related transaction costs and to increase benefits from regulation; and most informal wage workers would welcome more stable jobs and workers' rights.
Work in the informal economy is comprised mostly of survival activities and thus is not a subject for economic policy.	Informal enterprises include not only survival activities but also stable enterprises and dynamic growing businesses, and informal employment includes not only self-employment but also wage employment. All forms of informal employment are affected by most (if not all) economic policies.

### *Women and Men in the Informal Economy*

Compiling statistics on the size, composition and contribution of the informal economy is hampered by the lack of sufficient data. While many countries have now undertaken a survey on employment in the informal sector, very few countries undertake these on a regular basis. Furthermore, only a handful of countries have collected data to measure informal employment outside informal enterprises. In addition, the available data are not comprehensive. Many countries exclude agriculture from their measurement of the informal sector while others measure only the urban informal sector. In most developing countries, however, a majority of the informal workforce may well be in agriculture. There are also a number of problems that limit the international comparability of data. However, in the absence of reliable data collected directly, various indirect methods to estimate the size and composition of the informal economy can be used. What follows is a summary of main findings from the most recent and most comprehensive set of estimates of the informal economy in developing countries, including its gender dimensions, using indirect methods where necessary.<sup>3</sup>

#### *Size of the Informal Economy*

Informal employment broadly defined comprises one-half to three-quarters of non-agricultural employment in developing countries: specifically, 48 per cent in North Africa; 51 per cent in Latin America; 65 per cent in Asia; and 72 per cent in sub-Saharan Africa. If South Africa is excluded, the share of informal employment in non-agricultural employment rises to 78 per cent in sub-Saharan Africa; and if comparable data were available for other countries in South Asia in addition to India, the regional average for Asia would likely be much higher.

3 This section draws from an ILO statistical booklet prepared by Martha Chen and Joann Vanek that includes data compiled by Jacques Charmes for anywhere from 25-70 countries, depending on the specific estimate, as well as case studies for India, Mexico, South Africa and OECD countries (ILO 2002). Data available since 2002 were supplied by Jacques Charmes.

Some countries include informal employment in agriculture in their estimates. This significantly increases the proportion of informal employment: from 83 per cent of *non-agricultural* employment to 93 per cent of *total* employment in India; from 55 to 62 per cent in Mexico; and from 28 to 34 per cent in South Africa.

Informal employment is generally a larger source of employment for women than for men in the developing world. Other than in North Africa, where 43 per cent of women workers are in informal employment, 60 per cent or more of women non-agricultural workers in the developing world are informally employed. In sub-Saharan Africa, 84 per cent of women non-agricultural workers are informally employed compared to 63 per cent of men; and in Latin America the figures are 58 per cent of women in comparison to 48 per cent of men. In Asia, the proportion is 65 per cent for both women and men.

#### *Composition of the Informal Economy*

As noted earlier, the informal economy is comprised of both self-employment in informal enterprises (i.e., small and/or unregistered) and wage employment in informal jobs (i.e., without secure contracts, worker benefits or social protection). In developing regions, *self-employment* comprises a greater share of informal employment outside of agriculture (and even more inside of agriculture) than wage employment: specifically, self-employment represents 70 per cent of informal employment in sub-Saharan Africa, 62 per cent in North Africa, 60 per cent in Latin America and 59 per cent in Asia. If South Africa is excluded, since black-owned businesses prohibited during the apartheid era have only recently been recognized and reported, the share of self-employment in informal employment increases to 81 per cent in sub-Saharan Africa.

Informal *wage* employment is also significant in developing countries, comprising 30 to 40 per cent of total informal employment (outside of agriculture). Informal wage employment is comprised of employees of informal enterprises as well as various types of informal wage workers who work for formal enterprises, households or no fixed employer (see definition above).

### **Links with the formal economy and formal regulatory environment**

A key issue in the debates on the informal economy is whether and how the informal economy and formal economy are linked. However, these debates have tended to blur the distinction between the formal economy and the formal regulatory environment and the relationship of the informal enterprises and informal workers to each. But it is important to distinguish between the:

- *formal economy*: comprising regulated economic units and protected workers
- *formal regulatory environment*: comprising government policies, laws, and regulations

This section of the paper discusses the linkages between informal enterprises and workers and, respectively, the formal economy and the formal regulatory environment. In real life, of course, it is often hard to know what is driving what: as large formal registered enterprises are often involved in ‘setting’ formal policies and regulations; and formal policies and regulations are often biased towards formal registered firms to the disadvantage of both informal enterprises and informal wage workers.

#### ***The Formal Economy***

Over the years, the debates on the informal economy crystallized into three dominant schools of thought regarding the informal economy: dualism, structuralism, and legalism. Each of these has a different perspective on how the informal and formal economies are linked. The dualists argue that informal units and



activities have few (if any) linkages to the formal economy but, rather, operate as a distinct separate sector of the economy; and that informal workers comprise the less-advantaged sector of a dualistic labour market (Sethuraman, 1976; Tokman, 1978). Unlike the dualists, structuralists see the informal and formal economies as intrinsically linked. To increase competitiveness, capitalist firms in the formal economy are seen to reduce their input costs, including labour costs, by promoting informal production and employment relationships with subordinated economic units and workers. According to structuralists, both informal enterprises and informal wage workers are subordinated to the interests of capitalist development, providing cheap goods and services (Moser, 1978; Portes, Castells and Benton, 1989). The legalists focus on the relationship between informal entrepreneurs/enterprises and the formal regulatory environment, not formal firms. But they acknowledge that capitalist interests—what Hernando de Soto calls ‘mercantilist’ interests—collude with government to set the bureaucratic ‘rules of the game’ (de Soto, 1989).

Given the heterogeneity of the informal economy, there is some truth to each of these perspectives. But the reality of informal employment is more complex than these perspectives would suggest. What follows is a summary of various ways in which informal enterprises and workers are linked to formal firms.

#### *Informal Enterprises and Formal Firms*

Few informal enterprises, except perhaps some survival activities, operate in total isolation from formal firms. Most source raw materials from and/or supply finished goods to formal firms either directly or through intermediate (often informal) firms. Sourcing and supplying of goods or services can take place through *individual transactions* but are more likely to take place through a *sub-sector network* of commercial relationships or a *value chain* of sub-contracted relationships.

To understand the linkages between informal enterprises and formal firms it is important to consider the nature of the production system through which they are linked. This is because the nature of the linkage—specifically, the allocation of authority (over the work situation and the outcome of work done) and economic risk between the informal and formal firm—varies according to the nature of the production system. For instance, a garment maker might produce for the open market (with some authority and all of the risk) or for a supply firm linked to a multinational company (with little authority but much of the risk in the form of non-wage costs, rejected goods, and delayed payments). Types of production systems include:

- *individual transactions*: some informal enterprises or own account operators exchange goods and services with formal firms in what might be characterized as open or pure market exchange (in the sense of independent units transacting with each other). In such cases, the more competitive firm in terms of market knowledge and power – as well as the ability to adjust if the transaction does not proceed – controls the exchange or transaction.
- *sub-sectors*: many informal enterprises or own account operators produce and exchange goods and services with formal firms in what are called sub-sectors, networks of independent units involved in the production and distribution of a product or commodity. In such networks, individual units are involved in transactions with suppliers and customers. The terms and conditions of these transactions are governed largely by the more competitive firm in specific transactions (as above) but also by the ‘rules of the game’ for the sub-sector as a whole, which typically are determined by dominant firms in the sub-sector.
- *value chains*: some informal enterprises and own account operators and, by definition, all industrial outworkers produce goods within a value chain. The terms and conditions of production in value chains are determined largely by the lead firm: a large national firm in most

domestic chains and a large trans-national corporation in most global value chains. However, the major suppliers to whom the lead firm sub-contracts work—also often formal firms—also help determine the terms and conditions of work that they sub-contract to informal firms and workers down the chain.

In sum, in the manufacturing sector in particular, informal enterprises are quite likely to have linkages with formal firms. But these commercial relationships are not likely to be regulated, although this differs context to context. In the provision of services, such as catering, transport, and construction, there is greater possibility of de-linking from formal firms.

#### *Informal Workers and Formal Firms*

Historically, the ‘employment relationship’ has represented the cornerstone—the central legal concept—around which labour law and collective bargaining agreements have sought to recognize and protect the rights of workers. Whatever its precise definition in different national contexts, it has represented ‘a universal notion that links a person, called the employee (frequently referred to as ‘the worker’) with another person, called the employer to whom she or he provides labour or services under certain conditions in return for remuneration’ (ILO, 2003).

The concept of employment relationship has always excluded those workers who are self-employed. Increasingly, some wage workers have found themselves to be, in effect, without legal recognition or protection because their employment relationship is either:

- *disguised*: the employment relationship is deliberately disguised by giving it the appearance of a relationship of a different legal nature. For example, the lead firm in a sub-contracting chain may claim that it has a ‘sales-purchase’—or commercial—relationship with those who produce goods for it, rather than a sub-contracted employment relationship. In Ahmedabad City, India, many bidi traders now claim that they sell tobacco and other raw materials to those who produce bidis (hand-rolled cigarettes) and buy the finished bidis from them. This is because the bidi-rollers are trying to leverage employer contributions to a retirement fund from the bidi traders.
- *ambiguous*: the employment relationship is objectively ambiguous so there is doubt about whether an employment relationship really exists. This is the case, for instance, with street vendors who depend on a single supplier for goods or sell goods on commission for a distributor.
- *not clearly defined*: the employment relationship clearly exists but it is not clear who the employer is, what rights the worker has, and who is responsible for securing these rights. For example, in value chain production, it is not clear who the real employer is: the lead firm, the supply firm, or the sub-contractor? Similarly, in the case of temporary work, it is not clear who the real employer is: the agency that supplies temporary workers or the firms that hire them on a temporary basis? Or in the case of day labourers or seasonal labourers in agriculture and construction, whether the labour contractor or gang master is the employer?

Under each of these employment relationships, workers tend not to be protected under labour law or collective bargaining agreements: in brief, they are informally employed. It is important to note that, in many such cases, the employer seeks to disguise the employment relationship or avoid definition of who is responsible; and that the employer in question may well represent a formal firm, not an informal enterprise (ILO, 2003).

Beginning in the 1980s, formal firms in some developed countries began to favour flexible labour relationships. This form of labour market segmentation took place in the interest of flexible specialized production, not in response to rising wage rates or labour costs (Piore and Sabel, 1984). Also increasingly since the 1980s, many formal firms in developed countries have decided to sub-contract production to workers in developing countries: some of whom are relatively protected (e.g. those who work in call centres) while others are not protected (e.g. many of those who work in assembly factories). Production under this form of labour market segmentation takes place in developing countries where labour costs are low and there is no real threat of rising wages due to legislation or unionization. In producing countries, there is often further segmentation between the core semi-permanent workforce and a peripheral temporary workforce that is mobilized during peak seasons and demobilized during slack seasons (what has been called a 'permanent temporary workforce'). Depending on the context, the effect is to shift uncertainty from permanent employees to 'permanent temporary' employees or from 'permanent temporary' employees to industrial outworkers.

In sum, many formal firms prefer informal employment relationships, in the interest of flexible specialized production, global competition, or (simply) reduced labour costs. The related point is that formal firms choose these types of informal employment relationships as a means to avoiding their formal obligations as employers. In such cases, it is the formal firm not the informal worker that decides to operate informally and enjoys the 'benefits' of informality. This reality points to the need to re-examine the notion that informal employment is 'voluntary' from the perspective of informal wage workers, not just of the self-employed.

### *The Formal Regulatory Environment*

The three dominant schools of thought also view the relationship between the informal economy and the formal regulatory environment in different ways. In regard to informal enterprises, dualists pay relatively little attention to government regulations per se but focus instead on government provision of necessary support services: notably, credit and business development services. In regard to informal wage workers, some dualists subscribe to the neo-classical economics notion that government intervention in labour markets leads to wage rigidities which, in turn, lead to more informal employment. The legalists believe that government deregulation would lead to increased economic freedom and entrepreneurship among working people, especially in developing countries (de Soto, 1989). However, the founder of the legalist school—Hernando de Soto—recently advocated one form of regulation: namely, the *formalization* of property rights for the informal workforce to help them convert their informally-held assets into real assets (de Soto, 2000). In marked contrast, the structuralists see a role for government in regulating the unequal relationships between 'big businesses' and subordinated informal producers and workers: they advocate the regulation of commercial relations in the case of informal producers and the regulation of employment relations in the case of informal wage workers.

### *Over-Regulation*

As noted earlier, the legalists have focused on excessive regulations that create barriers to working formally. However, over-regulation may raise barriers and costs not only to operating formally but also to operating informally. Consider the case of gum collectors in India. Following the nationalization of the forests in India, gum and other forest products came under the control of the National and State Forest Departments with the result that trading these products requires a government license. Although there is a thriving open market for gum that includes textile and pharmaceutical companies, those who collect gum must sell gum to the Forest Development Corporation; to sell in the open market requires a special license. Most gum collec-

tors—except those who can afford to obtain a license—must sell to the Forest Development Corporation for below market prices (Crowell, 2003).

Consider also the case of salt makers in India. The cheapest way to transport salt within India is via railway. Historically, small salt producers have not been able to transport their salt by train because of a long-standing government regulation that stipulates that salt farmers need to own a minimum of 90 acres of land to be eligible to book a train wagon. Given that most small salt farmers lease land from the government or local landlords, most small salt farmers are not eligible to use rail transport. Because they have to use private transport, small salt farmers face high transportation costs and, therefore, remain less competitive than larger salt farmers (Crowell, 2003).

### *Deregulation*

As part of economic restructuring and liberalization, there has been a fair amount of *deregulation*, particularly of financial and labour markets. Deregulation of labour markets is associated with the rise of informalization or ‘flexible’ labour markets. It should be noted that workers are caught between two contradictory trends: *rapid flexibilization* of the employment relationship (making it easy for employers to contract and expand their workforce as needed) and *slow liberalization* of labour mobility (making it difficult for labour to move easily and quickly across borders or even to cities within the same country) (Chen, Vanek and Carr 2004).<sup>4</sup> Labour advocates have argued for *re-regulation* of labour markets to protect informal wage workers from the economic risks and uncertainty associated with flexibility and informalization.

### *Lack of Regulation*

The regulatory environment often overlooks whole categories of the informal economy. A *missing* regulatory environment can be as costly to informal operators as an *excessive* regulatory environment. For example, city governments tend to adopt either of two stances towards street trade: trying to eliminate it or turning a ‘blind eye’ to it. Either stance has a punitive effect: eviction, harassment, and the demand for bribes by police, municipal officials and other vested interests. Few cities have adopted a coherent policy—or set of regulations—towards street trade. Rather, most cities assign the ‘handling’ of street traders to those departments—such as the police—that deal with law and order (Bhowmik, 2004; Mitullah, 2004).

The different perspectives on regulation outlined above are appropriate for the specific components of the informal economy to which they refer: the legalists focus on informal *enterprises* (and informal *commercial* relationships); labour advocates focus on informal *jobs* (and informal *employment* relationships); and those concerned about street vendors focus on the regulation of *urban space* and *informal trade*. Arguably, for each component of the informal economy, what is needed is *appropriate regulation*, not complete deregulation or the lack of regulation.

## **Promoting More Equitable Linkages**

Given that the informal economy is here to stay and that the informal and formal economies are intrinsically linked, what is needed is an appropriate policy response that promotes more equitable linkages between the informal and formal economies and that balances the relative costs and benefits of working formally and informally. While the focus here is on the role of government, there is a role for all stakeholders, including for

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4 Liberalization of labour markets implies (a) wage flexibility, (b) flexibility in contractual arrangements, and (c) limited regulation in terms of the conditions under which labour is exchanged. It should be noted that international labour mobility is often excluded from discussions of labour market flexibility.

formal firms in promoting socially responsible corporate practices and for organizations of informal workers in policy making.

Reflecting the schools of thought outlined above, policymakers have taken differing stances on the informal economy: some view informal workers as a nuisance to be eliminated or regulated; others see them as a vulnerable group to be assisted through social policies; still others see them as entrepreneurs to be freed from government regulations. Another perspective sees the informal workforce as comprising unprotected producers and workers who need to be covered by labour legislation. Subscribing to one or another of these, policymakers have tended to over-react to the informal economy, trying to discourage it altogether, to treat it as a social problem or to promote it as a solution to economic stagnation.

But at the core of the debate on the informal economy is the oft-repeated and greatly misunderstood question of whether to ‘formalize’ the informal economy. However, it is not clear what is meant by ‘formalization’. To many policymakers, formalization means that informal enterprises should obtain a license, register their accounts, and pay taxes. But to the self-employed these represent the costs of entry into the formal economy. What they would like is to receive the benefits of operating formally in return for paying these costs, including: enforceable commercial contracts; legal ownership of their place of business and means of production; tax breaks and incentive packages to increase their competitiveness; membership in trade associations; and statutory social protection. But what about informal wage workers? To them, formalization means obtaining a formal wage job—or converting their current job into a formal job—with secure contract, worker benefits, and social protection.

Taking into account the different meanings of formalization, the feasibility of formalizing the informal economy is unclear. First, most bureaucracies would not be able to handle the volume of license applications and tax forms if all informal businesses formalized. Second, most bureaucracies would claim that they cannot afford to offer informal businesses the incentives and benefits that formal businesses receive. Third, recent trends suggest that employment growth is not keeping pace with the demand for jobs—there simply are not enough jobs to go around, especially given the very sharp rise in the proportion of people who are of working age in many countries. Finally, available evidence suggests that employers are more inclined to convert formal jobs into informal jobs—rather than the other way around.

The formalization debate should be turned on its head by recognizing, first, that formalization has different meanings for different segments of the informal economy and, second, that it is unlikely that most informal producers and workers can be formalized—although efforts should be made to do so. Further, the formalization debate needs to take into account the benefits due to informal enterprises if they operate formally and to wage workers if they get a formal job; and the costs of working informally for both the self-employed and the wage employed. The policy challenge is to decrease the costs of working informally and to increase the benefits of working formally.

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Pearce, J. (2003). Faculty Papers and Publications. Rethinking the Informal Economy: Linkages with the Formal Economy and the Formal Regulatory Environment. Martha Chen. Appointment. Lecturer in Public Policy. Office Address. 79 John F. Kennedy St. Brattle Sq 1, HKS 557. 617-495-0797.  
Linking the Formal and Informal Economy: Concepts and Policies. Ed. Basudeb Guha-Khasnobis, Ravi Kanbur, and Elinor Ostrom. Oxford University Press, 2006. 79 John F. Kennedy Street. Cambridge, MA 02138. 617-495-1100. Could the informal economy be the route to deliver the big sustainable development ideals such as the Green Economy, Millennium Development Goals and Poverty Reduction Strategies, given that its share is rapidly increasing and that the poor mostly operate here? In some developing countries, the share of the informal economy is greater than that of the formal economy.  
There are critical poverty/environment linkages associated with economic activity and the use by individuals of many environmental assets. The greatest assets for the poorest are often forests and other environmental services. These supply many rural small-scale enterprises with the raw material assets that they depend on for subsistence livelihoods.