Informal economy in emerging economies: not a substitute but a complement!

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Abstract
Contrary to the conventional belief of diminishing presence of informal entities in a more globalized world, there has been an upsurge in the size of the informal economy in the recent decades. The article summarizes the factors behind the existence and persistence of such economy and explains the advantages of the informal economy in reducing transaction costs, in sidestepping the bureaucratic obligations, and in complementing the formal economy. The paper refutes the idea that the informal firms act as a weak substitute for the formal firms. The paper uses anecdotal evidence and highlights the linkages between the two sectors.

1. Introduction

An informal economy refers to the "set of illegal yet legitimate (to some large groups) activities through which actors recognize and exploit opportunities" (Castells & Portes, 1989; Feige, 1990). A significant amount of activity takes place in the informal economy, suggesting its theoretical and practical importance. Schneider (2002) estimated that informal economy activities account for approximately 17 percent of gross domestic product (GDP) in developed economies and approximately 40 percent of GDP in developing economies. The World Bank estimates that this informal economy generates 40 percent of the GNP of low-income nations and 17 percent of the GNP of high-income ones. In some industries, such as retailing and construction, informality can account for as much as 80 percent of employment (Farell, 2004). According to the International Labor Organization (ILO) it "comprises half to three-quarters of all non-agricultural employment in developing countries" (http://www.ilo.org/global/topics/employment-promotion/informal-economy/lang--en/index.htm). Further, six countries (India, Brazil, Mexico, Vietnam, Pakistan, and the Philippines) constitute three-fourths of the total informal employments (ILO, 2012).

The informal economy grows when stringent tax laws, stiff regulations, and complicated bureaucracy make the formal economy unattractive in terms of high entry costs to the potential entrants. The concern of high entry cost is well documented in the existing literature, as shown by De Soto (1989) in the case of Peru, and further documented by Djankov, La Porta, Lopez-de- Silanes and Shleifer (2002) in their 85 country study. They observed that firms incur significant "entry costs", in the form of registration and license fees, in order to operate formally.

What is an informal economy?

The conceptual terrain of the informal economy intertwines several academic disciplines that span the last four decades. The term "informal sector" was first coined by social anthropologist Hart (1973) and analyzed by the International Labor Organization (hereafter referred to as the ILO) in its mission to Africa in the early 1970s. It encompasses an array of economic activities, from street vendors in Bangkok or Calcutta to garbage collectors in Cairo; rickshaw pullers in Dhaka to home-based garment workers in Manila, Mumbai or Mexico City;

home-based electronic workers in the Leeds or Kuala Lumpur to low priced software producers in Bangaluru Many definitions were introduced by different authors and ILO itself has redefined it several times. An excellent body of literature is available on this topic that covers statistical and ethnographic studies (Bromley,1978; Hart,1973; McGee & Bassett, 1976) and also studies related to the theoretical validity of the concept of the informal market along with its implications on developmental plans and policies (see for e.g., Smith, 1981; Sethuraman, 1976 ; Moser, 1984). Another branch of literature linked the informal market as a subsidiary of the prevailing capitalist system. This line of research has linked informal sector with the "petty commodity production", an integral part of a capitalist system (Moser, 1978; Babb, 1985).

In 1999, the international symposium of ILO categorized the workforce in the informal sector in three broad groups: "(a) owner-employers of micro enterprises, which employ a few paid workers, with or without apprentices; (b) own-account workers, who own and operate one-person business, who work alone or with the help of unpaid workers, generally family members and apprentices; and (c) dependent workers, paid or unpaid, including wage workers in micro enterprises, unpaid family workers, apprentices, contract labor, home workers and paid domestic workers." This contemporary definition of ILO separated the concept of 'informal economy' from other closely related notions, for instance, the formal economy, criminal economy or care economy. The formal economy is understood to be the world of regular, stable, and protected employment and of legally regulated activities. In addition, the informal economy should not be confused or conflated with the criminal economy.

While production or employment arrangements in the informal economy are often semi-legal or illegal, the informal economy produces and distributes legal goods and services. In contrast, the criminal economy deals with illegal goods and services. The care economy which is comprised of unpaid domestic work and care activities is also not part of the informal economy. This is because the informal economy is defined as part of the market economy: that is, as producing goods and services for sale or some other form of remunerations. Some early conceptualizations believed that the informal sector is simply too variegated and heterogeneous in order to be a meaningful concept to understand (Peattie, 1987; Peattie, 1980; Richardson, 1984). However, a growing body of recent research acknowledges that informal economy significantly contributes towards the employment and output of an economy and hence cannot be ignored (Goldberg and Pavcnik, 2003; Carr and Chen, 2004).

For instance, Tokman (1992) highlighted that the informal sector grew in Latin America and was a solace to the majority of working people during periods of economic crisis in the mid-1980. Relatedly, it was observed that millions of people who lost jobs during the East Asian economic crisis found employment in the informal economy (Lee, 1998). However, even before the Asian crisis, official statistics by the ILO indicated that the share of the informal economy in the nonagricultural work force ranged from over 55 percent in Latin America to 45-85 percent in different parts of Asia to nearly 80 percent in Africa (Charmes, 1998). Consequently, we can reasonably argue that the informal sector has and will continue to have an indelible impact on economic, political and social network and, therefore, needs to be better understood.

The remainder of the paper is organized along the following lines. The next section outlines the transformation of the informal sector to the new expanded concept of the "informal economy" that includes small entrepreneurs, own account operators, informal wage workers, and industrial out workers. Section three discusses extant literature and summarizes the motives behind the existence of such an economy. The related literature is vast though views are sparse and uncorrelated. The paper attempts to fill the lacuna that exists in the related field and presents all the motives in a diagrammatic form that identifies future research avenues. The international economic development of the informal economy is discussed next. Formal-informal linkages are explained in the context of emerging countries. The growing importance of the informal economy is stressed throughout this paper especially in understanding its role in the economies of the post- liberalization era.

2. The Genesis of Informal Sector

Early studies about the informal sector in less developed countries considered the informal sector as a subsistence level employment for the "reserve army of labor." Swaminathan (1991) claimed that "the substantial presence of the informal sector in those countries" as the main reason for mass poverty and unemployment. Fortuna and Prates (1989) noted that in developing countries the flourishing period of the export of manufactured items resulted in high levels of benefit for entrepreneurs, advancement in technology used, and growth in the scale of production. In addition, it promoted a process of going informally, disguised as small independent entrepreneurship. Grossman (1982) presented an interesting synopsis of various forms of informal activities that were utilized in the former USSR. He showed that demand for informal income and supply of informal goods and services reinforced each other and exchange of favors in terms of access to informal goods and services are prominent characteristics of informal sectors. Additionally, Kornai (1993), Schneider (1997) and Lacko (1998) provided theoretical and empirical evidence about the informal sector in former socialist countries.

The articles showed that the informal sector activities in those countries, especially in the last period before transition, were much more widespread than the commonly held belief that these countries experienced a relatively small informal sector, compared to developed countries. Johnson, McMillan, and Woodruff (1999) argued that in the transition countries that are exposed to a market economy, the informal economy cannot play any significant role. Informal activities cannot make use of market-supporting institutions (like courts of law) and this may discourage investments and economic growth. This has occurred in Peru, as reported by De Soto (1989). Kaufmann and Kaliberda (1996) shared the same viewpoint and claimed that even if it is large, the informal sector is mostly a survival sector where the short-term turnover dominates the long-term one, and where large-scale and vital investments do not take place. Table 1 provides representative studies of informal economy post millennia.

Table1:SummaryofRepresentativeStudieson Informal Economy

Author(s)	Setting	Key Arguments/Findings
Akintoye, 2008	Case Study with Informal sector of Nigeria	Informal Sector backed by state support reduces the unemployment rate.
Anjaria, Jonathan Shapiro, 2006	Street Vendors in Mumbai, India	Predatory behavior of the state against the street vendors.
Carr and Chen, 2004	Globalization, Informal Employment, and Gender	Unfavorable terms of inclusion in various aspects of work and employment are important drivers of poverty and inequality.
Chen, 2007	Informal-Formal Economy Linkage	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.
Djankov et al 2002	Data on the regulation of entry of start-up firms in 85 countries	Countries with heavier regulation of entry have higher corruption and larger informal economies than countries with the lighter regulation of entry.
Friedman et al, 2000	Macro data from 69 countries	Higher tax rates are associated with less informal activity as a percent of GDP but corruption is associated with the more informal activity.

Godfrey, 2011	Model of Informal Economy	Provided a 2x2 matrix and analyzed the presence of informal economy
Goldberg and Pavcnik,2003	Brazil and Colombia, country-level study	The study examines the response of the informal sector to liberalization. In Brazil, no evidence of a relationship between trade policy and informality is found. In Colombia, evidence of such a relationship is found, but only for a specific time period.
Kesteloot and Meert, 1999	Different categories of the informal economy and their spatial distribution in the geographical setting of Brussels	Offers a powerful tool to understand informal economic activities as a set of interrelations between households and other economic actors in order to gain access to their living resources
Kus, 2010	Macro-level study across a broad set of countries	Countries have different types of regulatory environments that help explain why some nations have more informal economic activity than others.
La Porta and Shleifer 2008	World Bank firm level data	Informal firms are small and unproductive, compared even to the small formal firms, and especially relative to the larger formal firms. Growth comes from the creation of the highly productive formal firms.
Maloney, 2004	Latin American informal sector	Forward a view of the informal sector in developing countries primarily as an unregulated micro-entrepreneurial sector and not as a disadvantaged residual of segmented labor markets
Ordóñez, 2010	Informal sector and economic development	Informality is associated with resource misallocation. This is drivenby the government inability to enforce tax and regulation policies on all firms. As a result, the tax base is small, and high taxes have to be levied on a small subset of firms, usually the most productive ones.
Portes, and Schauffler, 1993.	Latin American informal sector	Offer views of the informal economy not as a manifestation of the problem of poverty but a potential solution to it.
Schneider, 2005		The average size of the shadow economy as a proportion of official GDP in 1999–2000 in developing countries was 41%, in transition countries 38%, and in OECD countries 17%.
Porto, 2005	Case study with informal economy from Moldova	Reducing export barriers for the informal sector would benefit the average Moldovan household across the whole income distribution. Poverty would also decline, affecting 100–180 thousand individuals.
Turnovsky and Basher 2009	The interdependence between tax policy and enforcement in a developing economy that has a substantial informal presence	Judicious policy choices ensure that the presence of the informal sector need not hinder its ability to raise tax revenues
William and Round, 2007	Russia, 313 households during 2005/06	Examining the multiple types of informal employment, more positive impacts emerge as it is the key seedbed for enterprise development and principal mechanism for delivering community self-help.

According to the ILO (2012), informal economy, broadly defined, comprises of one-half or three -quarters of the non-agricultural employment in developing countries: 48 percent in North Africa; 51 percent in Latin America; 65 percent in Asia; and 72 percent in sub-Saharan Africa. Informal employment is comprised of both self-employments 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 all developing regions, self-employment comprises a greater share of informal employment (outside of agriculture) than wage employment: specifically, self- employment represents 70 percent of informal employment in sub-Saharan Africa, 62 percent in North Africa, 60 percent in Latin America and 59 percent in

Asia. Three categories of informal wage employment- self-employment, part-time work, and temporary work – comprise 30 percent of overall employment in 15 European countries and 25 percent of total employment in the United States. Table 2 reported the 5- year data of the percentage of informal workers in agriculture and in the non-agriculture sector from 2009-2013 in a selected number of developing countries (based on the data availability from the International Labor Organization)

Table 2: Data from Selected Developing Countries

	Agricultural Economy Activity			Non-Agriculture Economic Activity		
Year	# of Countries	Mean	Standard Deviation	# of Countries	Mean	Standard Deviation
2009	NA	NA	NA	20	52.96%	17.53
2010	NA	NA	NA	21	55%	21.35
2011	7	85.35%	11.72	17	46.50%	20.6
2012	10	89.37%	12.36	20	49.25%	24.35
2013	8	85.99%	11.96	20	47.20%	23.1

*Average % of informal workers in the agricultural economic activity for that year based off the International Labor Organization's data when refining the search to total sex's and national geographic coverage.

**Average % of informal workers in the non- agricultural economic activity for that year based off the International Labor Organization's data when refining the search to total sex's and national geographic coverage

Table 2 reflects that for the non-agriculture economic activity (see the list of countries in the appendix below) the number of informal workers contributes fifty percent of total workforce. The number is significantly larger in the agricultural activity, both reflecting the importance of the informal sector in the growth and development of a developing nation.

3. Drivers of informality: Existence and Persistence

3.1. *Existence*

Why do entities and entrepreneurs operate informally? The literature offers four-fold explanations though the reasons are not mutually exclusive and each demands a distinct policy implication. First, entrepreneurs operate informally when the tax rates are high and other official regulations are grueling (De Soto, 1989; Schneider and Enste, 2000). Reduction in the tax rate and relatively quicker unbinding of red tape are considered to be the ways to induce the entrepreneurs to operate formally. Second, informal sectors can also emerge from predatory behaviors of government officials who extract bribes from registered firms (Shleifer and Vishny, 1993; Kaufmann, 1994; Shleifer and Vishny, 1994; Kaufmann, 1997; Shleifer, 1997; Shleifer and Vishny, 1998; S. Johnson, Kaufmann, and Zoido-Lobaton, 1998). The plausible solution according to this line of argument is to address bureaucratic corruption. In addition, firms' may seek to hide their activities to avoid extortion from antisocial groups or criminal gangs (Zhuravskaya and Frye, 2000). As De Soto (1989) documented in the Peruvian economy that small entrepreneurs do not expand their business even if they can, in order to avoid the mafia threats. According to this view, the state needs to enforce a better law and order system to protect the entrepreneurs from antisocial elements.

The role of the state in terms high regulation costs in the formal sector motivate participation in the informal sector (Gershuny, 1979). Most common government regulations are related to environment protection, consumer protection, quality control, labor protection in terms of the inflexible formal labor market, and financial capital availability. Of all types of regulations, labor protections in various forms, such as minimum wages, fringe benefits, social security benefits and strong labor union considerably increases the cost of staying formal. Tokman (1992) in his study of Latin American countries reported that such regulations increase labor costs by an average of around 20 percent. A similar study had been done by Nipon (1991) for informal businesses in Thailand found that by ignoring labor-protection laws, these businesses save about 13 to 22 percent of labor wages.

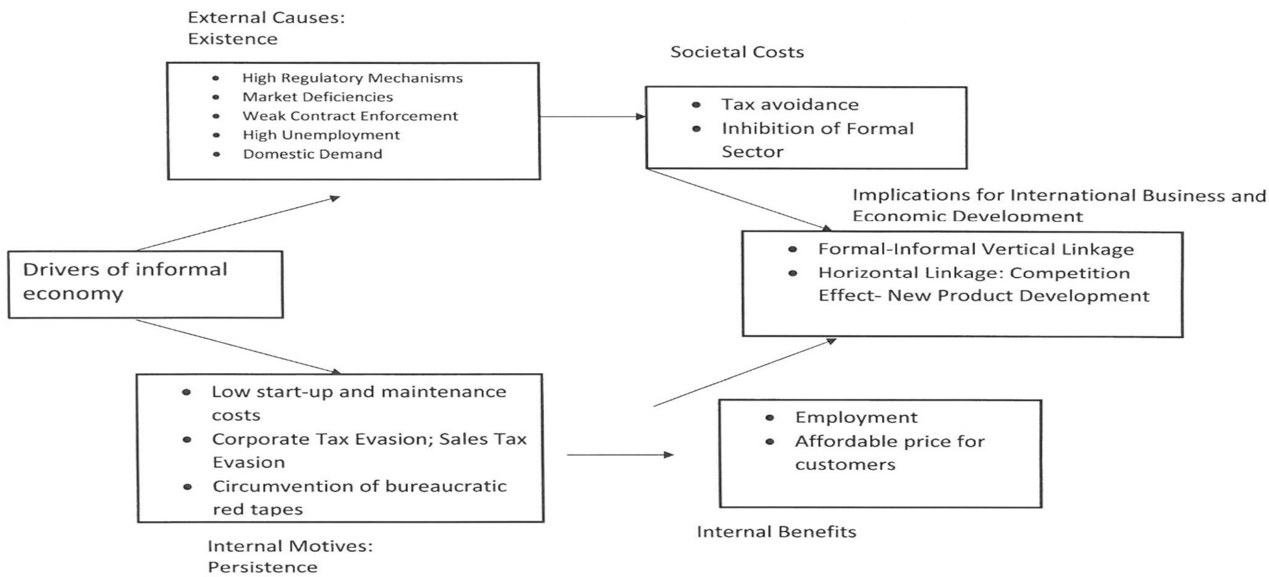
Finally, the existence of informal sectors in many countries could be due to the presence of inadequate and inefficient institutional environments. For example, a weak contract enforcement environment and ineffective legal system may discourage entrepreneurs from operating in a formal environment. Bhattacharya and Ghose (1998) note that informality is a response to the pervasive level of bureaucratic corruption: they show that foreign firms in India avoid reporting sales and income in order to protect themselves from the reach of corrupt police, tax, and bureaucracy.

3.2. Persistence

Why do entities and entrepreneurs continue to operate informally? Are there external motives as mentioned in the previous paragraphs or there are internal reasons for those entities to persist informally? The rationality of staying informal can be analyzed considering the cost and benefits that a legal status entails. The costs of formality can be divided into costs of entry and costs to remain formal. For a potential entrant in the formal sector, there are certain costs to the entrance. The access costs that are often highlighted in the literature are bribes to the government officials to complete the registration process or to obtain the license and other requirements. De Soto (1989) studied the informal sector in Peru. The author conducted a few real-time experiments in order to quantify the entry cost. The study revealed that the total cost of registration and license was equivalent to 32 times the minimum monthly salary that was prevalent at that time. In addition, it took almost ten months to complete the registration process. In another study, Tokman (1992) reported similar results for other Latin American countries. To circumvent such costs, many firms continue to stay in the informal sector.

The costs of staying formal can be further categorized into taxes, government regulations, and bureaucratic obligations. Tax collected from the formal sector is an important source of government revenue. In developing countries, corporate income taxes are set up at a higher level to compensate for its lack of well-administered tax system, required in order to efficiently monitor the informal firms. Burgess and Stern (1993), in their study, reported that in developing countries, corporate income taxes represent 17.8 percent of total tax revenues, while individual income taxes, only 10.6 percent. In contrast, for industrial countries, corporate income taxes account for only 7.6 percent of total tax revenues while individual income taxes constitute 27.7 percent. Bureaucratic obligations are also a significant cost of continuing in the formal sector. As discussed in Alonzo (1991) for the Philippines, and Chickering and Salahdine (1991) for Egypt, bureaucratic obligations to unbind the red tape and to finish the paperwork is time-consuming and an arduous task for the entrepreneurs. Next, we present a thematic diagram that presents the tone of the previous sections and sets up the discussion section that follows:

Figure 1



4. Implications for Economic Development

Studies related to the informal economy in the field of emerging economies have gained momentum with increasing attention on emerging markets (McGahan, 2012; Godfrey, 2011; Carpenter et al., 2001; Spreitzer, 1997). Organizations need a group of global managers who are able to manage the necessary global integration and cross-border coordination activities within or between organizations. These trends suggest a compelling need for managerial commitment to developing or acquiring international expertise as global markets continue to expand. Along with that line, focusing research on the dynamics of the informal sector is a valuable contribution to the field of international business in particular and organizational management in general. In spite of the recognition of the importance of research pertaining to informal economy and its intricate relationship with institutional developments of emerging economies (Hambrick and Mason, 1984), inadequate effort and attention have been devoted to better understand the factors that contribute to the development of such economies, and the theoretical and practical implications of such development. The present paper seeks to draw attention in the related field to fill this lacuna in international business and management literature.

Informal Economy and Vertical Linkage

For instance, India has achieved an average of significantly high annual growth for the last two decades. Conventional wisdom depicted informal sectors as weak substitutes for its formal counterparts and hence predicted that greater integration in the world market would shrink informal markets in size and capacity in the emerging economies. As the ILO study (2002) and Chen (2004) suggest that the informal economy in India has also expanded simultaneously. Such a paradox can be explained from the direct vertical linkage of the formal and the informal economies. India primarily grew due to the supernormal growth of the Indian service sector. Such growth in emerging market economies was well supported through an excellent and cost effective supply chain mechanism. Informal suppliers provided cost-effective resources that helped the large firms to stay competitive globally. Partly because, the cost of operating informally is less, the suppliers stayed cost effective and competitive. Below, we present a table that illustrates the presence of informal employment in the formal sector[1].

Table 3: Informal Workers in the Formal Sector for Selected Countries

Countries in 2009	% of informal workers in the formal sector*	Countries in 2010	% of informal workers in the formal sector*
Argentina	64.7	China	98
Armenia	75.9	Colombia (II)	58.4
Brazil	53.1	Liberia	66.1
Costa Rice	58.4	FYR Macedonia	85.2
Dominican Republic	61.9	Serbia	84.9
Ecuador	70.2	South Africa (IV)	39
El Salvador	59.7	Uganda	67.5
Honduras	78.4	West Bank Gaza	81.3
India (2009-2010)	88.4	India (2009-2010)	88.4
Indonesia	79.4	Pakistan (2009-2010)	95
Mexico	67.9		
Moldova	90.4		
Pakistan (2009-2010)	95		
Panama	64.2		
Paraguay	69.9		
Peru	80		
Sri Lanka	90.3		
Uruguay	40.7		
Venezuela	89.4		
Vietnam	59.5		

*Informal employment outside the informal sector, i.e. employees holding informal jobs in formal enterprises (incl. government units and non-profit-institutions) or as contributing family workers in formal enterprises.

The data collected from the International Labor Organization reveals the significant contribution of informal workers to the formal sector. The data refers to a crucial implication, about the two sectors that looking at these two sectors as separate and mutually exclusive entities would be incomplete. Rather, it should be acknowledged from the start that the activities that are normally considered part of the informal economy are often in one way or another linked to the activities in the formal economy (Portes, Guarnizo, and Haller, 2002; Gereffi, 1999; Lund and Srinivas, 2000). The supply chain vertical aspect of formal and informal linkage needs further attention as it has not been explored effectively yet. Evidence from Bangladesh garment industry suggests the importance of informal workers who operate at informal sector. They offer low-end labor of the value chain with sewing, stitching, and packing at a low piece rate that allows the formal garment enterprises to stay globally competitive. Though the huge gap in the profit distribution is clearly something that needs to get the attention of the policymakers. Laborers at the lowest level (or the start) of the chain receive very little return relative to the final sale price of a commodity or a good.

Informal Economy and the Horizontal Linkage

In a similar vein, the formal-informal linkage may have horizontal aspects too. In recent years, intra-industry competition has not only intensified, its nature has fundamentally changed: it has become more knowledge-based, and the sources of competitive advantage have shifted unmistakably from physical assets to intellectual resources (Prahalad and Hamel, 1990; Quinn, 1992; Stewart, 1997). This is particularly true for the emerging market formal firms attempting to stay competitive internationally. Here again, informal firms in the same industry play a crucial role. Because of the lax of strong enforcement of property rights in the emerging markets, the knowledge transfer is quite pervasive. Hence, the emulation of a product by the informal firms, and selling it at a cheaper price puts the formal firms at a disadvantage. One way to overcome this challenge is to stay innovative through new product developments. Again, this horizontal competition from the informal firms' act as a boon in disguise for the formal firms and requires further academic attention in the field of international business.

5. Conclusion

The informal economy is huge and it is safe to predict that the informal economy is going to persist as well. In fact, depending on how informal economy is defined, it might be the most dominant model of economic organization, and hence calls for an appropriate policy response that can promote equitable linkages between formal and informal economies. All stakeholders that include government and formal firms require understanding the importance of incorporating informal economies in policy making. Surveys like Global Competitiveness Report, surveys of entrepreneurs about their own activities, or the World Bank Enterprise Surveys that collect data from entrepreneurs and managers in both formal and informal firms on their sales and inputs, employee and manager education, as well as a variety of assessments of the institutional environment, can shed further light on the role of the informal economy in management practices and in international business.

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