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How Robust a Concept is the Informal Economy and How Large is its Scope?

A Few Sketchy Comments

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## **How Robust a Concept is the Informal Economy and How Large is its Scope? A Few Sketchy Comments**

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### **Introduction**

Since their inception in the early 1970s, the concepts of informal employment and the informal economy have been the locus of fruitful analyses, but also of ongoing confusion. Every decade since the first international compilation from the OECD (Charmes, 1990), updates have brought together a rising number of data (ILO 2002, 2013, 2018 and 2019) that are increasingly harmonised through the adoption of international definitions (ILO, 1993; 2003).

Some investigations use carelessly the informal economy terminology (Ohnsorge and Yu, 2021) without referring to the origins of the concept of informality in Hart (1971) and the ILO report on Kenya (ILO 1972); other studies analyse the shadow economy (Medina and Schneider, 2019) or various models of informality (Albertini et al., 2020), which do not fit.

Ongoing research over half a century suggests that the concept of informal economy proves a happy heuristics, but also encapsulates diverse theories and distinct methodologies lacking consensus, which rather coins informality as a “fuzzy set”, namely the overlap of multi-criteria analyses. Thus, confusion remains between the informal economy, the non-observed economy and the shadow economy, and this confusion affects the policies and regulations relating to informality in developing countries.

In the first place, I single out the theories addressing the causes of persistent informality. Then, I go back to the genesis of the extensive concept of informality that remains controversial, with respect to the informal sector and the business approach *versus* informal employment and job status, and its nested components. Last, I discuss the reliability of data sources and I compare the informal economy, a subset of the Non-Observed Economy, and the shadow economy.

### **1. Theories of Informality and Causes of Persistence**

Dell'Anno (2021) points out a first series of three conceptual approaches - “Modernisation”, “Dualist” and “Structuralist”, whereby the first two cover two distinct interpretations of the dualist model, then a second series of three approaches - “Parasitism”, “Neoliberalism” and “Segmentation” -, whereby the first two refer to the institutionalist approach, whereas “Segmentation” is linked to “Dualist”. These two series are classified according to eight criteria: key idea, main types of activities, causalities, voluntary or constrained choice, political implications, link with the formal economy, prevalence by country and reference theorist.

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Unsurprisingly, such a large combination (64 elements) emphasizes out the absence of a universal theory of informality, various hypotheses proving not mutually exclusive. This is a “fuzzy set” with distinct overlapping elements.

Actually, a threefold spectrum of various theories of informality proves sufficient, namely dualism (Lewis, 1954; Harris and Todaro, 1970) and labour market segmentation (Fields, 1975), structuralism and subordination of informality to formality (Castells and Portes, 1989) and institutionalism and micro-enterprises (De Soto, 1986). There are several causes of persistent informality. The main cause is low employment growth, as the formal economy is not able to provide jobs for a growing labour force. Hence, economies have not reached Lewis’ “turning point,” which occurs when the labour surplus is fully absorbed (Ranis, 2004). This is consistent with segmentation theory, which does not preclude occupational mobility.

The other main cause is the inadequacy of the regulatory framework and the lack of enforcement over the execution of employment contracts and the inspection of social security. Excessive regulation by the State, which encourages the informal sector and micro-enterprises to operate outside the regulations, takes place within the institutionalist theory.

## **2. The informal economy, the genesis of an extensive though controversial definition**

Informality includes three components: the informal sector, informal activities in the formal sector and households.

### **2.1. The informal sector and the business approach**

Hart (1973) merely lists a long series of survival activities (“informal income opportunities”) he observed in Ghana; the introduction of the ILO report on employment in Kenya (ILO, 1972) does address and define implicitly the informal sector using a list of seven criteria, exactly opposing those defining the formal sector. The content or the terminology of the concept can be traced back in a chapter of the third revision of the United Nations System of National Accounts -SNA (United Nations, 1968). It proposes to classify establishments according to two modes of production, the modern and the traditional, and to encapsulate into the latter all household production activities in the form of sole proprietorships, the characteristics of which (size and organisation) will later be included in the multi-criteria definition of the ILO report on Kenya. These themes developed in all subsequent revisions of the SNA under the name of the informal sector as a sub-sector of the household account. Meanwhile, the ILO (1993) had coined the informal sector as including unincorporated enterprises, a subset of the institutional household sector, comprising both own-account workers and employers. These economic units,

which provide legal market production, with fewer than five paid permanent employees, are not registered or their employees are not.

## **2.2. Informal employment and job status**

The definition of informality through the enterprise approach failed to capture the new forms of precarious employment that seem to be increasingly used by formal sector enterprises facing widespread competition as a result of the globalisation process. It was therefore supplemented by a definition based on the nature of job holding. According to the ILO (2003), informal employment covers all jobs carried out both in informal and formal enterprises by workers who are not subject to labour regulation, income tax or social protection. It comes from the lack of reporting of jobs - casual or short-term - or employees, whose number of hours or wages stands below a specified threshold, occupied outside the premises of the employer's enterprise. The expanded definition is based on non-payment of social contribution rather than lack of social protection, as individuals can access social protection through the contribution of another family member (Charmes, 2019, 18) or certain forms of non-contributory social protection. Theoretically, informal employment encapsulates the informal sector, as do Russian dolls.

## **2.3. The informal economy: nested components**

The vagueness of the definitions of employment in the informal sector and of informal employment lies in the range of possible choices among various criteria. With respect to the informal sector, namely size, registration of the enterprise or its employees, and as regards employment, namely lack of a written contract or absence of contribution to a social protection system (health care, retirement scheme, employment advantages, etc.), which depend on the data available in the countries.

Informal employment or employment in the informal economy ultimately includes three main components. (i) Employment in the informal sector is generally the most important component; (ii) informal employment in the formal sector; and (iii) informal employment in households corresponding to paid domestic workers and household members producing goods and services for their own final use, which extends informality to unpaid domestic work. In terms of national accounts, noteworthy is that informal employment in enterprises belonging to the formal sector is no longer part of the institutional household sector.

The ILO (2015) defines the informal economy as “all economic activities of workers and economic units that are not or insufficiently covered by formal arrangements in law or practice”. However, the ILO (2018b, 22) states that “the informal economy is not a statistical concept but a political concept that covers the sum of all parts of informality.”

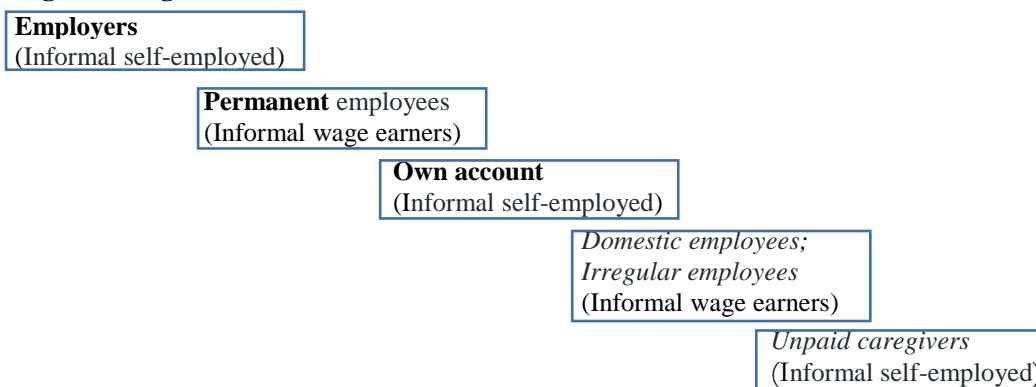
The evolution of the concept of informality, initiated in 1993 and continued in 2003, is far from being closed. In particular, the digital revolution and the platform economy blur the boundaries between wage-employment and self-employment, leading today to revisit the concept.

Ongoing discussions within the ILO (2021) gave birth to two new provisional concepts. The *informal productive activities economy* (IPAE) is defined as “all productive activities carried out by persons and economic units which, in law or practice, are not covered by formal arrangements” (ILO, 2021, 7). The *informal market economy* (IME) includes “all productive activities performed by workers and economic units for remuneration or profit that are not covered – in law or practice – by formal arrangements” (ILO, 2021, 11). The informal market (IME) is a subset of the informal productive market and informal non-market activities.

Until recently, the International Classification of Employment Status (ICSE) included five statuses: employee, employer, own-account worker, unpaid family worker (contributing to production), and member of producer cooperatives. The 2018 revision (International Classification of Statutes at Work) introduces a new category, “dependent contractor” (i.e. false self-employment) as a subcategory of dependent workers (ILO, 2018c).

According to Chen (2020), four variables measure the different segments of informal employment: employment status, place of work, branch of economic activity and gender of the worker.

**Figure 1. Segmentation of informal workers by status and income (vulnerability)**



*Note:* In bold, mainly male workers. In italics, mainly female workers.

*Source:* adapted from Chen et al. (2020, 71).

Employment status largely determines the working conditions of the job and whether the job is formal or informal is directly related to employment status. Employees represent the status generally associated with greater job security and better working conditions; own-account workers and family workers contributing to (unpaid) production are two vulnerable categories. However, informal workers without social protection are also vulnerable, while some self-employed and family workers are not vulnerable (Chen, 2020). Vulnerable inactive young

people (NEETs) who are not in employment, education or training should also be mentioned, a phenomenon that particularly affects women in Morocco and Tunisia (Adair et al., 2022). Figure 1 identifies vulnerable categories of workers

### **3.1. Reliable data sources for measuring the informal economy and other concepts**

#### **3.1. Are there reliable data sources for measuring the informal economy?**

Data collection initiated by Charmes (1990) was maintained within the framework of WIEGO (Women in Informal Employment: Globalizing and Organizing) from 1997, then taken up by the ILO as part of the joint publication “*Women and Men in the Informal Economy. A Statistical Picture*” (ILO 2002, 2013, 2018a) on an ever-increasing number of countries (25 in 2002, 47 in 2013, and 100 in 2018). Levels of granularity allow multiple crossings (by sex, urban/rural environment, employment status, sector of activity, etc.). However, the ILO (2018a) expands the number of estimates and cross-reference them with a number of other variables. In so doing, it relies on micro-data from household surveys and applies algorithms for defining informal employment and employment in the informal sector to calculate macro indicators, i.e. modelled estimates.

Such modelled estimates are used for purposes for which they are not intended, driving disputable interpretations. In addition, the systematic use of micro-data has encouraged the use of surveys with less coverage, the results of which significantly overestimate the informality rate as compared to the results of quarterly employment surveys. Noteworthy it is not the case with the ILOSTAT database, which covers employment or living conditions surveys of official households in 78 countries. However, some countries such as Algeria and Morocco do not disclose their data to ILOSTAT.

North Africa is the region wherein which the macroeconomic estimates of the informal economy have been the most numerous since the 1970s (Charmes, 2019).

As for the magnitude of informality, North Africa is in the low range (48.7%) of non-farm informal employment compared to the worldwide average (59.6%) over 2010-14 (Charmes, 2019).

Non-farm informal employment rate for the four North African countries over the 2010-2020 decade is heterogeneous as regards both trend and share. There is a downward trend in Algeria (with 37.2% been the lowest share) and Morocco (with 66.2% been the highest share), whereas it is going upward in Egypt (with a 56.3% share) and Tunisia (with a 39.9% share), the average of the region experiencing a slightly upward trend just below fifty per cent (Charmes and Adair, 2022).

### 3.2. The Informal economy, the Non-Observed Economy, and the Shadow Economy

Table 2 presents the Non-Observed Economy (NOE), a comprehensive typology of productive activities that aims to redress GDP according to national accounts, one of which is a large part of the informal economy. This is an approach to the search for completeness in national accounts and the calculation of GDP, which was the subject of the OECD handbook (2003) and the Eurostat tabular approach in 2014.

**Table 2. The Non-Observed Economy (NOE): five categories and seven types of output**

Market		Market Legal			Non-Market Legal
<b>Illegal</b>	<b>Subterranean</b>	<b>Informal</b>		<b>Statistical deficiencies</b>	<b>Own final use</b>
<i>Criminal (N2)</i>	<i>Not registered (N1) + Under declared (N6)</i>	<i>Not surveyed (N4) + Registered not surveyed (N5)</i>		<i>Other deficiencies(N7)</i>	<i>Registration not requested (N3)</i>

Source: Eurostat (2014) in Adair (2020).

Noteworthy is that the inclusion of own final use output, generally gauged by time use surveys, remains tricky in terms of articulation with labour force concepts.

At the same time, macro-econometric assessments from a calibrated structural model (MIMIC) or dynamic general equilibrium (DGE) models covering a broader but undetermined spectrum of the NOE and overestimate adjusted GDP. This shadow economy modelling provides cheap annual estimates (time-series) for more than 150 countries over a long period (since 1990). Unsurprisingly, it has attracted both the major international financial institutions (The World Bank and the IMF) and academic researchers. However, definitions and metrics do not match informality.

A controversy highlights the shortcomings and weaknesses of these macroeconomic models (Feige, 2016a and b, Schneider 2016), which disqualify the method to provide any reliable estimate of the shadow economy. First, the size of this economy in a given country and for a given year changes through the various publications of the author or authors, depending on the changes in the list of variables, their calibration and various other assumptions of the model. Second, the method is supposed to provide an index of changes in the shadow economy's time but it does not calculate its size itself, which results from external sources including Schneider (2016) claims that they are obtained from previous studies mainly based on the currency demand method. However, monetary methods are themselves based on strong assumptions such as the identification of a reference year that is uncertain. Schneider refers the burden of proof to any source in the past, as the objective is to assess a trend. Last, shadow economy estimates are frequently presented as a measure of GDP underestimates, although a greater or lesser proportion of these are already included in GDP.

## Conclusion

In order to cut a long story short, informality is a dynamic concept that looks to the future and remain grounded on achievements so far. It requires both ongoing thorough investigation and taking stock of stylised facts. Quarterly surveys that were disrupted in several countries by the Covid-19 pandemics must resume data collection for assessment. This is a preliminary requisite for policies addressing the formalisation of informality.

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