

The Informality Lens

Ravi Kanbur

www.kanbur.dyson.cornell.edu

Plenary Presentation, GDN Annual Conference, Budapest,
June 17, 2012

Outline

- Introduction
- Conceptualizing Informality
- Informality: Magnitudes and Trends
- A Simple Framework
- Explaining Informality Trends
- Policy Divides on Informality
- Conclusion: Research Areas

Introduction

- “...informal sector employment and underemployment....have aggravated urban poverty.”
- Informality is a prominent feature of the urban landscape in developing countries.
- There is a strong association between poverty and informality (despite some heterogeneity).
- With development, urbanization is meant to increase, and informality is meant to decline. The first is happening, the second is not.
- There are very different views on policy responses to informality—from deregulation to even more state intervention.

Some Writings

- Basudeb Guha-Khasnobis, Ravi Kanbur and Elinor Ostrom (Editors), *Linking the Formal and Informal Economy: Concepts and Policies*, Oxford University Press, 2006.
- Ravi Kanbur, “Conceptualising Informality: Regulation and Enforcement,” V.V. Giri Memorial Lecture, *Indian Journal of Labour Economics*, Vol. 52, No. 1, pp. 33-42, 2009.
- Arnab Basu, Nancy Chau and Ravi Kanbur, “Contractual Dualism, Market Power and Informality,” 2011, <http://kanbur.dyson.cornell.edu/papers/BasuChauKanburContractualDualism.pdf>
- Ravi Kanbur, “Avoiding Informality Traps”, in E. Ghani (ed.), *Reshaping Tomorrow: Is South Asia Ready for the Big Leap?*, pp. 260-278, Oxford University Press, 2011.
- Anushree Sinha and Ravi Kanbur, *Informality: Concepts Facts and Models*, Special Issue of *Margin: The Journal of Applied Economics Research*, NCAER, Delhi, May 2012.

Conceptualizing Informality (1)

- No clear and consistent conceptualization in the literature. Overlapping, sometimes competing, views. Linked very much to the notion of the dual economy. Each strand in the literature highlights one or other aspect, and is also present in the complexities of the policy discourse.

Conceptualizing Informality (2)

- Boeke (1943). Dualism between activities that came under purview of the colonial regime and those that did not. “Order” versus “disorder.”
 - But note, the notion of “disorder” contested by Ostrom (1970).
- Lewis (1954). Dualism between capitalist and “traditional” mode of production. Not necessarily rural versus urban eg capitalist agriculture or urban informal (“the whole range of casual jobs-the workers on the docks, the young men who rush forward asking to carry your bag as you appear, the jobbing gardener, and the like.”).

Conceptualizing Informality (3)

- Harris and Todaro (1970).
 - Formal jobs in the urban sector, where wage was higher than market clearing, either because of state regulation (minimum wage) or unions.
 - Informal jobs where market cleared through wage adjustment.
 - Rural to urban migration balanced probability of getting formal job versus ending up with a low income in the informal sector.

Conceptualizing Informality (4)

- Hart (1973). “‘Formal’ incomes came from regulated economic activities and ‘informal’ incomes, both legal and illegal, lay beyond the scope of regulation.” (Hart, 2006).
- ILO (1993). Unincorporated enterprises.
“...enterprises owned by individuals or households that are not constituted as separate legal entities independently of their owners, and for which no complete accounts are available.”

Conceptualizing Informality (5)

- India's NCEUS (2008).
 - “The informal sector consists of all unincorporated private enterprises...with less than ten total workers...
 - Informal workers consist of those working in the informal sector or households, excluding regular workers with social security benefits by the employers, and the workers in the formal sector without any employment and social security benefits provided by the employers.”

Conceptualizing Informality (6)

- Hernando De Soto (2003). Back to “umbrella of the law.”
 - Related more to property rights than worker rights.
 - “Trillion dollars of equity” tied up in urban slums.
 - Could be released by extending formal legal structures to the informal sector.
 - But criticisms, including possible distributional implications if formal legal structures favor the well off.

Conceptualizing Informality (7)

- No clear and consistent conceptualization in the literature.
- Each strand in the literature highlights one or other aspect, and is also present in the complexities of the policy discourse.
- However, perhaps a useful generalization is that “formal” relates to coming within the ambit of state regulation.
- This still leaves a lot of leeway—regulation of what? Of what type? Measurement of informality requires further specification, as does policy analysis.

Informality: Magnitudes and Trends (1)

- Internationally comparable measurement (ILO) is transitioning from an enterprise based perspective to a worker based perspective:
 - Informal sector: self-employed (employers, own account workers, family helpers) + wage employees + employers in micro-enterprises (less than five workers)
 - Informal workers: Individuals in Informal Sector (above) PLUS Wage employees in the Formal Sector without social protection

Informality: Magnitudes and Trends (2)

- Figures from OECD (2009). Share of Informal Employment in Total Non-Agricultural Employment, rounded average and range:
 - Sub-Saharan Africa: 75% (50%-95%)
 - South and East Asia: 70% (50%-85%)
 - Latin America: 55% (35% -75%)
 - Western Asia: 50% (30%-55%)
 - North Africa: 45% (35%-70%)
 - Transition Economies: 20% (10%-45%)

Informality: Magnitudes and Trends (3)

- Old established regularity: in a cross-section of countries, there is a negative relationship between informality and per capita income.
- However, in many countries informality does not seem to have declined at all in the last two decades. For example, from OECD (2009), rounded averages:
 - India, 75% in 1985-89 to 85% in 1995-99
 - Egypt, 35% in 1985-89 to 45% in 2000
 - Morocco, 55% in 1985-89 to 65% in 2000
 - Guinea, 65% in 1980-84 to 85% in 1995-99

Informality: Magnitudes and Trends (4)

- BUT, some different results from World Bank (2011):
 - No change for Bangladesh (2002-2008) and Pakistan (2002-2008)
 - Decrease for India (2000-2005) and Sri Lanka (2000-2008)
 - Increase for Bhutan (2003-2007) and Nepal (1998-2008).
- Differences are also due to differences in sources and in definitions of informality.
- Nevertheless, the PRESUMPTION that informality will decline with per capita income seems to be questioned.
- If informality is not declining as rapidly as was presumed would happen, two questions arise: (i) Why? (ii) What can and should be done about it?

A Simple Framework (1)

- Imagine a world without state laws and regulations into which laws and regulations are introduced. Economic agents have to decide how to respond.
- For concreteness, consider a law which says that all enterprises with 10 or more workers have to register and pay certain benefits to their workers.
- This creates several categories of activities.

A Simple Framework (2)

- A. Within the ambit of the laws and complying.
- B. Within the ambit of the laws but not complying.
- C. Adjusted activity to go outside the ambit of the law.
- D. Always outside the ambit of the law

A Simple Framework (3)

- A is Formal. B + C + D is Informal.
- Let it be stipulated that this framework is simple.
- Of course there are cross-linkages eg some in D supply those in A, etc etc.
- But the key point is that Informality itself is of three types: Evaders (B), Avoiders (C) and Outsiders (D).
- Explanation of Informality Trends, and Discussion of Informality Policy, will have to disaggregate to (at least) these three categories.
- However, we do not really have solid empirical estimates of the magnitudes of these different categories.

Explaining Informality Trends (1)

- For those activities that could be formal but choose not to be, ie choice of A, B or C, the choice depends on the relative costs and benefits of complying with the regulation, not complying with the regulation, or adjusting out of the ambit of the regulation.
- These costs and benefits in turn depend intricately on (i) returns to scale (in our example), which depends on technology, (ii) costs of complying with the regulation and (iii) effectiveness of enforcement.

Explaining Informality Trends (2)

- If technology evolves to make scale economies less strong, then avoidance will be less costly (ie some activity will move from A to C). Thus informality as conventionally measured ($B + C + D$) will go up.
- If enforcement effort declines, so that the probability of getting caught (and/or the punishment when you are caught) goes down, then category B (evasion) will expand, but it will draw both from category A and category C. Informality as conventionally measured ($B + C + D$) will go up.
- Given technology and given enforcement, if regulation weakens, for example, if only firms with 15 workers or more are required to register, then category A will decline (under certain conditions), and $B + C + D$ will rise, ie measured informality will rise, although relative composition of B, C and D may change.

Explaining Informality Trends (3)

- This is the theory. What is the evidence on the relative causes of informality trends?
- Basically, we have no systematic credible evidence. At least not that I am aware of.
- We have speculation and anecdotes, for example on labor inspectors “turning a blind eye” on violations of labor law. We have discussions of this or that regulation being weakened.
- No doubt all this is happening. But we do not have systematic evidence on these as causal factors, especially in relation to evolution of technology, for which we have some but not comprehensive evidence that efficiency of operation at smaller scales is greater than it used to be.
- Thus—much targeted research is needed to explain trends in informality.

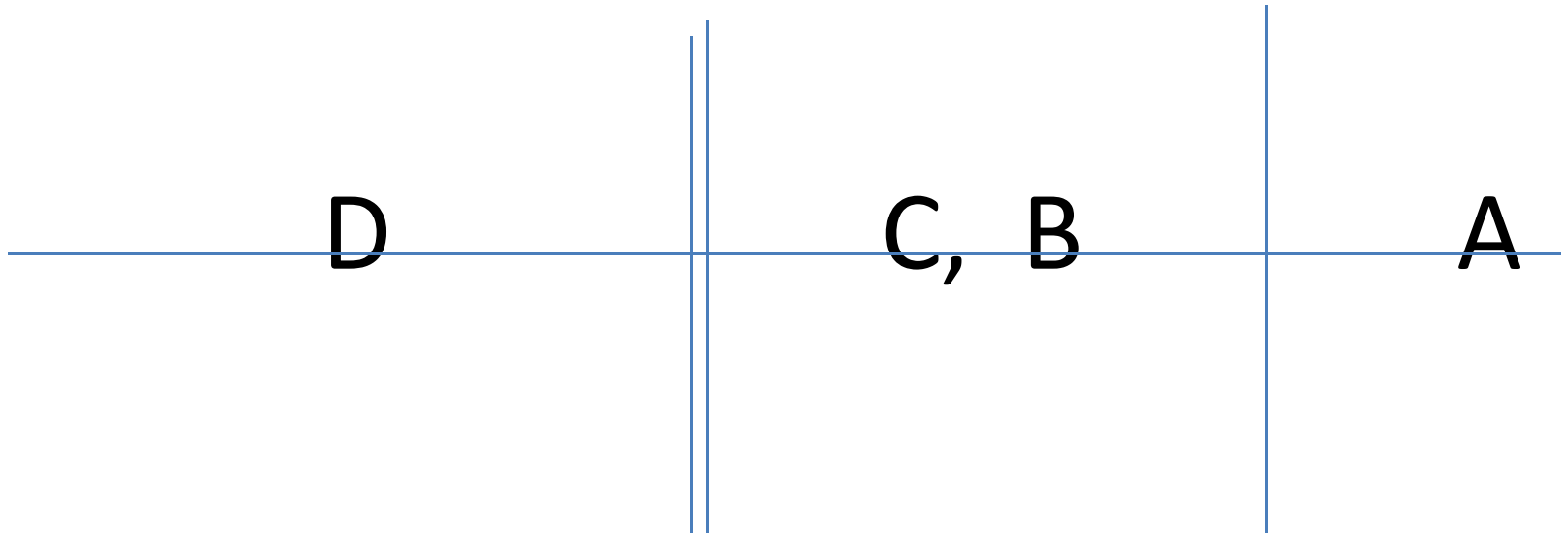
Policy Divides on Informality (1)

- “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.”
– *The Economist (2010)*
- “.....labour market rigidities alone cannot explain the extent of informal employment...”
– *Chen and Doane (2008)*

Policy Divides on Informality (3)

- The first view leads to a focus on the regulation which B /C are trying to evade/avoid.
- The second view leads to a focus on the productivity of D, which is very far removed from any impact of the regulation.

Policy Divides on Informality (4)



Policy Divides on Informality (5)

- 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?

Policy Divides on Informality (6)

- What are the productivity differences between D and B + C?
- What can increase productivity in D?

Policy Divides on Informality (7)

- If the objective is greatest sustainable impact on poverty, then is it a higher priority to use limited financial, administrative and political resources to (i) raise productivity in D or (ii) reforming regulations to reduce adjustment out of A into B and C?
- I *think* many elements of civil society would say (i). I *think* The Economist would say (ii).
- I *know* that we do not have sufficient research to provide the answer with confidence.

Conclusion: Further Research (1)

- The study of urbanization has to involve the study of informality.
- Informality is an old and much investigated topic in development studies.
- This might lead some to think that whatever needs to be said has already been said—that there are no new research areas.
- I hope I have shown that a whole stream of conceptual, empirical and policy questions remain unanswered.

Conclusion: Further Research (2)

- And I have only been able to cover an “enterprises” and “employment” perspective in my presentation.
- There are many other important perspectives on informality. For example:
 - The “property rights” perspective of Hernando de Soto
 - The “organization” perspective of the late Elinor Ostrom.
 - The rural-urban migration perspective.

Conclusion: Further Research (3)

- So, informality remains and will remain a central phenomenon in development policy research!

Thank You!