

Institutions, interests and informality and the role of the informal economy and firms in productive transformation.

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The informal economy is usually defined as a residual. It comprises all economic activities and actors that do not belong to the formal economy. This makes it very heterogeneous and somewhat nebulous. It covers everything from the shoe-shine boys trying to irk out a living on the pavements in cities in developing countries to well-educated and prosperous entrepreneurs who for one reason or another prefer not to formalise their activities. Before we begin to discuss it, it is therefore necessary to unpack the concept somewhat.

In the first instance we need to distinguish between two types of informal economic activities and actors.

1. Economic activities that yield or at least have the potential of yielding a reasonable income and which are primarily developed and driven by pull-factors, such as perceived business opportunities.
2. Distress activities and distress employment, which people are pushed into for lack of alternative sources of income. Push factors and not pull factors are the driving forces behind the development of this type of informal activities. For all practical purposes it can be seen and should be treated as a form of disguised unemployment. The solution does not lie in formalisation, but in the development of alternative decent job opportunities elsewhere in the economy.

A special variety of this case is when *the informal sector serves as a waiting room for labour en route from agriculture to formal non-farm employment*. I.e. what one might term a Harris-Todaro type of informal economy.

Although there is obviously a grey zone between these two types of informal activities, I believe it is both possible and useful to make a distinction between the two. In developing countries a practical lithmus test is if the productivity and incomes are below those in agriculture.

An additional useful distinction is between agriculture and non-farm informal economic activities.

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I will exclusively focus on the former type of informal activities and actors, that is on those that are driven by pull, rather than push factors. I will also primarily, but not exclusively talk about non-farm informal activities.

Institutions and informality

The non-farm informal economy can be seen as resulting from a disharmony between the regulatory and institutional framework on the one hand and the specific nature and needs of the economy and economic actors on the other hand. The shape of an economy and of the economic development depends to a large extent on the interplay between the economic actors and the regulatory and institutional framework, including the policy framework. The regulatory and institutional framework, provides the setting – the playing field – as well as the rules of the game. It can be more or less conducive or enabling, it can also favour some economic actors over others. While it has to have a certain rigidity in order to provide a clear and predictable framework – rules of the game – it must also be flexible in order to adjust to and support, but also to shape, a transformation of the economy.

Causes behind informality

Moving beyond this somewhat trivial conclusion: What are some of the causes and interests that serve to create and preserve informality? What are the most common barriers and disincentives to formalisation?

These take a number of different forms and shapes, let me just single out a few

Red tape, high regulatory costs in terms of time and money to set up and run a business.

This aspect has received much welcome attention, not least through the work of the World Bank and IFC on the business and investment climate and one should also mention ILO's work on creating an enabling environment for sustainable enterprises.

These costs are often more or less fixed, which implies that in relative terms they are much higher for small economic actors than for large ones and they often serve as an effective barrier for small new actors to become formal. It seems clear that these barriers can have a serious detrimental effect on economic development on general and not least on structural change. It increases the rigidity of the economy and makes Schumpeterian creative destruction more cumbersome.

Taxes and levies are another often quoted reason behind a reluctance to become formal. Levies on enterprises to cover the cost of social protection and excessively stringent regulations for termination of employment (as a poor substitute for publicly funded unemployment benefits) can add to the disincentives for firms to become formal and to make informal employment formal.

A more sinister variety of this type of causes is when barriers are used by insiders to shield themselves from competition from outsiders.

These kind of barriers are found both within countries and at the global level. The guilds and the monopoly they had on engaging in specific economic activities provide a historic example. More recent examples can be found in the now abandoned Chinese policy of ‘walking on two legs’, of segregating by administrative means the rural labour force from the urban, or for that matter in the previous apartheid policies in South Africa. These systems have in common the creation of dual economies, where the insiders have assumed privileges and rights that are exclusive to themselves rather than universal and protect these through barriers that keep outsiders out.

Such practices also take on global dimensions.

Globally, irregular labour migration stands out as a prime example. A case in point is the EU, where today several million irregular migrant workers are de facto accepted and, indeed, evidently very much needed, in the host countries, but denied legal status. Thus, a dual labour market has been created where high levels of remuneration and extensive labour rights for the domestic labour force in the formal labour market is upheld in the face of increasing global competition by supplementing it with cheap migrant labour who are prevented from becoming formal.

Let me give one example. The shoe industry in a southern EU country which in the 1990s recruited thousands of Albanian mostly irregular migrants without work or residence permits, who worked for about a third of the wage of their Italian co-workers in the same enterprises. It would seem that in the short term everybody gained. The enterprises survived despite increasing competitiveness from Asia, the domestic workers kept their jobs and relatively high wages, the local government got revenues and even the Albanian workers were perhaps better off than they would have been at home. Still, it was undeniably exploitation, and it was hardly conducive to a sound economic transformation in the long term.

Within countries, too, we can arguably also find cases where politically well-connected interest groups and organisations collude to protect the interests of those inside the formal sector from competition from those who are outside.

Linkages between the informal and the formal economy

This brings us to the nature of the linkages and relationship between the formal and informal economy. I believe that broadly speaking three types can be identified.

- **Symbiotic**, situations where informal firms offer flexibility to formal firms which due to regulatory factors or other are less flexible. The relationship between the urban state industries and the TVEs in China is, or at least used to be, a good example of this. There are also many examples from other countries, such as India and Indonesia, just to

mention a few where various forms of sub-contracting or out-sourcing from formal firms to informal businesses are thriving. Through these relationship, informal firms gain access to markets, inputs and at times technology and credit, while the formal firms gain in flexibility and reduced costs.

- **Mutually dependent, but unequal, i.e. The Apartheid case.** Here the relationship is largely exploitative and can hardly be characterised as symbiotic.
- **Competitive relationship.** This would primarily seem to be the case when there are barriers to interaction between the formal and the informal firms and actors. One important factor behind such barriers is often the tax system, or more precisely VAT. As informal firms do not pay VAT they can neither charge nor deduct it. This obviously creates an obstacle to transactions between formal and informal firms. More specifically, it implies that informal firms cannot afford to buy inputs and services from formal enterprises as they will be charged a VAT which they cannot subsequently deduct. This can be a severe handicap and it also makes it very difficult for informal firms to acquire technology and knowhow from firms in the formal economy.

The role of VAT in driving a wedge between the formal and the informal economy is far from trivial. One only has to look at the plight of the millions of newly de-collectivised small-scale farms in Eastern Europe in the 1990s. There are obviously many reasons behind the relative failure of small-scale agriculture in these countries since the collapse of socialism, but the introduction of very high rates of VAT clearly served make it very difficult for them to link up with and become integrated in value added chains as in most instances they did not have formal status and were charged, but could not deduct VAT.

Is informality an obstacle to productive transformation or do informal firms have a role to play in such a transformation?

There are some empirical proof to show that informal firms can indeed play a constructive role in a productive transformation. I will give one example. Vietnam. In 1991 I was involved in doing a survey of private manufacturing enterprises in Vietnam.² This was in the very early days of the Doi Moi and private small-scale enterprises were only just beginning to become politically acceptable. In 1997, six years later, we did a repeat survey where we went back to the previously surveyed enterprises to find out what had happened to them. One particular category was household enterprises, which for all practical purposes were informal.

² Per Ronnas and Bhargavi Ramamurthy, eds. *Entrepreneurship in Vietnam: Transformation and Dynamics* (Singapore and Copenhagen: ISEAS and NIAS, 2001).

We found that among the urban household enterprises, about a third had closed down and an additional 13 per cent were declining. More importantly, we found that 37 per cent of these enterprises had grown in terms of value added by more than 10 per cent per year. Indeed, a quarter of them had grown by a remarkable 20 per cent per year or more, which had resulted in a total transformation of these enterprises. Their assets had increased many-fold, productivity had more than doubled and their technology had been greatly upgraded and their market outreach had increased significantly. They had become part and parcel of an exceptionally rapid productive transformation process. A range of factors made this remarkable development possible. Among them was no doubt a rapid change in the overall institutional environment in Vietnam in this period. It was a good example of an institutional change in tandem with a rapid economic transformation within the context of an overall liberalisation of the economy and a move from a highly restrictive political environment where private entrepreneurship was at best perceived as a necessary evil, to the acceptance of a market-based economy.

Hence, in certain specific situations it is clearly possible also for informal firms to become involved in and contribute to a productive transformation process. Still, I would argue that this is probably an exception to the rule. I think that there are strong reasons to believe that in most instances informality is detrimental to a sound productive transformation. I will conclude by putting forward two arguments:

At the firm level, we know that informality is a constraint on endogenous enterprise growth. This is primarily because transaction costs of informal firms tend to increase exponentially with the size of their operation, making it difficult for small firms to grow while remaining informal. Informal firms depend on personal contacts, information and trust, which tends to confine their activities to the local environment, where people know who is who and know each other. They lack legal recognition and protection, legal means of contract enforcement are not open to them, they often have to maintain low visibility which confines marketing efforts to 'the word of mouth' etc.

At the national level, widespread informality is as discussed earlier an indication of an inappropriate and somewhat dysfunctional regulatory and institutional environment. It also often reflects undue influence by insiders over the shaping of the rules of the game, which in its turn inevitably influences and shapes the economic development. It is hard to see that this could in any way be conducive to a sound productive transformation.