

A THEMATIC SCAN OF THE LITERATURE ON THE INFORMAL ECONOMY

Abstract

A literature review developed for the research paper
'Shadow Economies: Economic Survival Strategies of Toronto Immigrant Communities'

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January 2012

Informal Economy

1. Definition and General Characteristics of an 'Informal Economy'

There is no single concept of an informal economy. What is referred to as an informal economy is actually a diverse mixture of economic practices. Furthermore, there is no consensus on the definition of practices that make up the informal economy. A diverse range of informal activities such as domestic do-it-yourself work, tax evasion, self-help, mutual aid and smuggling have been generally lumped together into one category, thus creating much confusion. Part of the reason for this has been the lack of systematic data available which would allow for these types of activities to be thoroughly investigated. No one actually understands just how large the informal economy is. The IMF estimates that it accounted for 14-16 % of GDP in 21 advanced economies from the years 1988 to 2000 (Daniels, 2004, p.506).

Traditionally, the informal economy has been perceived to be made up of mainly survivalist economic activities. It has been defined mostly in negative terms ranging from undeclared labour, tax evasion, unregulated enterprises, illegal and criminal activity. This traditional approach sees the informal economy as something peripheral and not otherwise linked to the formal economy. Over the last decades, it has become clear that the informal economy has significant potential to generate income and jobs. There is growing consensus that the informal economy is large and growing, and that it will become a central feature of the economy in both developed and developing worlds. Hence, in a definitional sense, the idea of an informal sector is being replaced by the notion of an informal economy with broader impacts and networks, in this way getting away from the idea that informality is confined to a specific sector of economic activity. Indeed, the evidence is growing that informal economic activity cuts across many different sectors.

Because of its complexity, the informal economy is the subject of many definitions. However, defining the informal economy according to the economic activities conducted is the most common. Henry and Sills (2006, p.264) distinguish 5 types of informal economic activities on the basis of whether they use currency or barter as a medium of exchange, whether activities are parasitic in nature with respect to the regular economy and whether or not economic activities are legal.

- a. **Irregular informal economic activity** refers to the production and consumption of goods and services outside of regular employment using money as a medium of exchange. Insofar as these activities are unregistered, they avoid a variety of taxation and other laws designed to protect the health and safety of employers and consumers, and as such are illegal although they have been referred to as quasi legal, rather than criminal.
- b. **Informal hidden economic activity** refers to the production and consumption of goods and services deriving from activities that are parasitic on regular employment, using employer's time, resources and markets for personal gain and using money as a medium of exchange. Insofar as these activities often involve pilfering, embezzlement, time theft and the sale of stolen goods, they are criminal.
- c. **Informal unofficial economic activity** operates inside legitimate formal employment as a way to get around rules and processes, typically not using money but favours, privileges and perks as a means of exchange. They are not parasitic, nor are they illegal.
- d. **Informal social economy** operates outside of formal employment and uses barter rather than money as a medium of exchange. It typically operates among members of a single neighbourhood and through households by way of self-help and mutual aid.
- e. **Criminal economy** refers to illegal exchange or drugs, vices etc., that takes place via organized crime and gangs.

Colin C. Williams (2008, p. 107)), approaches the informal economy through informal work. He separates three types of informal work. *Self-provisioning work* refers to unpaid household work undertaken by household members. *Unpaid community work*, on the other hand, refers to unpaid work conducted by household members by and for the extended family, social or neighbourhood networks and more formal voluntary and community groups, and ranges from volunteering to kinship exchange. *Paid informal work* can be defined as all monetized exchange that is unregistered or hidden from state tax, social security and/or labour laws but which is legal in all other respects.

The informal economy can also be described through various employment categories such as self-employment, wage workers and employers.

To conclude, because of its intrinsic heterogeneity, there are many ways of defining the informal economy. This is not necessarily an obstacle for further analysis, however. Although some early definitions included criminal activities and many categories of unpaid work, such as domestic labour, more precise working definitions of the informal economy have recently been formulated. The informal economy is best understood as **all economic activities that are hidden from or ignored by the state for tax, social security and/or labour law purposes but which are legal in all other aspects.**

Maybe the best way to characterize the informal economy is through the paradoxes it creates. Portes and Haller (2005) specified four such paradoxes:

- a. The more the informal economy functions in the absence of state regulations, the more it is dependent on social ties for its effective functioning. Without state regulation, for example, there would be no sanctions for fraudulent actions other than penalty of exclusion from the social ties and from future transactions.
- b. The official efforts to control unregulated activities through tight rules and regulations often expand the very conditions that give rise to informal economic activities. If there were no taxes imposed, there would be no tax evasion.
- c. The more credible the state enforcement apparatus is, the more likely its record-keeping mechanism will miss the actual extent of the informal economy and, hence, the weaker the basis for developing policies to address it. In places where the informal economy is widespread and semi-open as in many developing countries, it is possible to arrive at reliable estimates of its size on the basis of direct surveys.
- d. The informal economy commonly yields a series of positive effects for the state, the very institution charged with its suppression. It has a cushioning function as it employs and provides incomes to a large segment of the population, while lowering the costs of consumption at the same time.

2. Theoretical Perspectives on the Informal Economy

The debate on the informal economy, which mostly revolves around the relationship between formal and informal economies, has been shaped by two opposing perspectives. While the critical perspectives include a modernization approach, the marginalization thesis and the Marxist structural analysis, proponents of the informal economy include neo-liberals, green thought and post-capitalist theory

approaches. Currently, many studies are focused on the importance of going beyond the debate between these two perspectives and formulating an alternative third path.

a. Critical Perspectives

Modernization approach sees the “informal economy as a residue” (William, 2008, p.107). According to this approach, the informal economy is attributed to underdeveloped societies. It is considered to be a stage in a linear universal developmental path toward progress which is then equated with the Western developed world where “formalization” has replaced the informal economy. Hence, the informal economy is traditional, less-developed and a temporary stage only to be replaced by the formal economy as the economy develops. Clearly, this approach sees the formal and the informal economy as separate entities with the formal being superior to the informal. The modernization approach has been criticized on many different levels: from being Eurocentric to being empirically wrong. The existence of a strong informal economy in advanced Western societies has clearly discredited the assumption of such thing as a universal path toward formalization.

Marginalization thesis approaches the informal economy as a by-product of the formal economy (William, 2008, p.111). According to this view, modern industrial society encourages the informal economy in a number of ways (Henry, 1981). It creates low income categories as well as ethnic and cultural segregation in the name of lowering costs, which means that many people have relatively low or non-existent incomes. It fails to provide goods and services for these groups at price levels they can afford. Hence, a market for cheap goods and services is created outside the formal economy. In sum, the informal economy is considered as being no more than a temporary buffer or survivor mechanism for those who have no choice. This thesis cannot explain, however, how and why informal work is greater amongst the formally employed rather than the employed. “As such, at best, it is an explanation for the existence and growth of some fragments of the informal economy” (William, 2008, p.113)

Marxist structural analysis argues that the informal economy is a replication of the dominant capitalist class structure. It is dependent on the formal economy, and workers in the informal economy are no more than disguised wage labourers. The informal economy has its own exploitation structure very similar to the capitalist class structure. “The working unemployed become the working classes of the informal economy whose “middle class” are dominated by the employed moonlighters, pilferers and fiddlers, and whose upper classes are commanded by the tax-evading self-employed” (Henry, 1981,

p.471). While the Marxist analysis is better at explaining the involvement of employed populations in informal work, it is a reductionist binary approach to understanding the formal and the informal economy.

What is common to all of these three critical perspectives is their assumption that the formal economy is separate from the informal economy with clearly defined boundaries. They all, although in different ways, privilege the formal economy while denigrating the informal economy as a negative phenomenon.

b. Proponents of the Informal Economy

Informal economy as supportive of the formal economy. According to this thesis, the formal economy is problematic and the informal sector can serve and complement the formal economy in a way that helps overcome the negatives associated with it. Most of these negatives are associated with the increasingly precarious status of formal employment, where more workers are part-time, temporary, low-paid, working on contract or holding multiple jobs creating insecurity as well as the stress and anxiety suffered by those at the lower end of the labour market. Reiner (p.42) summarizes the primary functions of the informal economy in support of the formal economy. First, the informal economy acts as a buffer or social safety net during economic recessions. It enables poor people to obtain the same service as middle class people at rates they can afford. Second, it supports the formal economy through the reproduction and sustenance of labour. Third, it provides an important source of social cohesion. And last, it provides a remedy for social exclusion by providing social support, security and services. As stated earlier, the informal economy plays an important role in building and maintaining social cohesion by reducing the stress and anxiety of people struggling to make ends meet. In addition, the informal economy can also be considered as a capacity-builder. Most of the skills learned in informal work such as home renovation, cooking, child and adult care are transferable to the formal economy. The informal economy also supports the establishment of trust and information transfer which is essential for the market. In addition, funds spent in the informal sector remain in the local setting, which in turn improve neighbourhood conditions. It has “the effect of increasing social capital by bonding people to one another and providing opportunities for informal contact (Gold, p. 17).

The informal economy as an alternative to the formal economy. This approach goes one step further in its criticism of the formal economy and proposes that the growth of the informal economy can lead to the demise of the formal economy. The informal economy is “seen as a vehicle for entrepreneurial

innovation, as the human side of capitalist enterprise, and even as the vanguard for an alternative society” (Henry, 1981, p.460) There are three perspectives that exist under this approach (Williams, 2008, p.115). For *neo-liberals*, 'informalization' is the result of over-regulation of the market and the informal economy provides long overdue positive encouragement for the functioning of the “true market.” Because of the absence of state regulation, informal transactions are portrayed as a reflection of pure market forces (Portes and Haller, 2005, p.406). According to *green thought*, the informal economy reduces the centrality of a formal economy (with the formal economy understood to be encouraging environmental degradation). In *post-capitalist thinking* the view that the formal economy is hegemonic leads people to believe that there is no alternative. There is, therefore, a need to recognize, value and create informal economic practices (Williams, 2008, p.115).

In conclusion, the proponents of the informal economy argue that the informal economy is much better than the formal economy in satisfying the needs of people at the lower end of the economic hierarchy and in catering to “the specific and just-in-time production demands of cutting edge firms and efficiently allocating luxury consumables prized by the high income populations that work for them” (Gold, p.9). “For example, subcontractors, who are often members of immigrant or ethnic groups, permit major firms to rapidly and inexpensively manufacture products for global cities” (Gold, p.10). It is important to realize that in spite of their romantic appeal, informal economies are subject to inequalities, injustices and abuses. In the absence of state regulation, there are no guarantees that those subcontractors will not exploit their workers, pay properly or follow health and safety regulations. Another criticism is that the proponents of the informal economy fail to see that by providing buffer for the poor, the informal economy creates an excuse to avoid social change.

c. Third Path - Towards a Better Understanding of the Informal Economy

There seem to be 2 major problems with the approaches discussed above, whether they criticize or defend the informal economy (Williams, 2008, p. 117). First, they all assume that there is one universal relationship between the formal and the informal economy whether one is superior to the other or one is supportive of the other. Second, they all view the realms of the formal and the informal as separate, stable and bounded realms. In this way, “a gross injustice is done to the complex and multiple relationships that exist between informal and formal work in lived experience” (Ibid). These opposing approaches tend to reduce the informal economy to one monolithic entity. In reality, there is no single

cause for the informal economy; its existence can be explained by a complex interplay of economic, political, cultural and urban forces.

As many authors suggest, the boundaries of the formal and informal economies are blurred at best. The only reason to maintain a sense of difference between formal and informal activities is to be able to examine their interrelationship more precisely. Some even question the usefulness of using the concepts of “formal” and “informal” activities and calls for abandoning using such terms (Daniels, p.507). It is not clear, however, how collapsing these activities into one undifferentiated whole will be useful analytically or empirically. More sophisticated approaches analyze the interrelationship between formal and informal economies showing that “the informal economy is universal, irrespective of the level of a country’s development and regardless of the presence or absence of immigrant labour; that its form changes even in the same society, region or city...[it] is not a set of survival activities performed by destitute people on the margins of society but a specific form of income generating production relationship that cuts across the whole social structure” (Henry and Sills, p.274). In sum, the informal economy can be understood as a process of economic restructuring where 'informalization' is a necessary outcome of the trends toward deregulation, downsizing and increased competition. It seems that our long held traditional definition of “economic activity” itself is at stake here. The complexity of the informal economy as well as the interrelationship between formal and informal activities calls for more research to better understand the new sense of “economic activity.” Such research will be a challenge given the difficulties associated with measuring the size of the informal economy.

3. Measuring the Informal Economy

Because of its very nature as economic activity outside of state regulations, the informal economy is difficult to measure. In most cases, a variety of methods for estimating have been devised to make determinations at the individual level, or at the level of households or ethnographic studies.

4. Indirect measurement methods

The labor market approach estimates the size of the informal economy on the basis of specific employment categories. The assumption is that people who are employed in these employment categories are more prone to conceal all or some of their income from taxing authorities (Portes and Haller, p.413). The self-employed, the unemployed, the occupationally inactive, domestic servants and workers in micro-enterprises that employ up to five workers are all suspect.

The small-firm approach is based on the evaluation of the number and proportion of “very small enterprises” as an indicator of informal activities (Portes and Haller, p. 415). Very small enterprises (VSE) are defined as those businesses employing fewer than ten workers. It is assumed that most activities considered to be informal occur in smaller enterprises because of their lower visibility, greater flexibility and greater opportunities to escape state controls. Both labour market and small-firm approaches suffer from two obvious problems. First, not all small firms or people in specified employment categories engage in informal activities. Measuring those can lead to overestimating the size of the informal economy. Second, some small enterprises or people are fully informal and they escape all government recording, which leads to underestimation.

Macroeconomic estimates approach uses the macroeconomic discrepancy method. It attempts to measure the size of the informal economy as a proportion of Gross National Product (GDP). This method is based on the existence of at least two different but comparable measures of some aspect of a national economy. Discrepancies between these measurements are then attributed to informal activities. For example, gaps in the income and expenditure side of national accounts can be used to estimate the size of unreported income. In Canada, in early 1990s this method yielded an estimate of 21.6 percent of GDP, but the official figure from Statistics Canada remained at 2.7 percent (Portes and Haller, p.417). This approach does not differentiate between criminal and informal economies, which leads to, again, the overestimation of the size of the informal economy.

b. Direct measurement methods

The Household consumption survey method is based on measurement of the consumption of informally provided goods and services by households. (Portes and Haller, p.416). This approach relies on a statistically representative survey, where respondents are asked to report the amounts spent over preceding years on goods and services acquired off-the-record or on-the-side. This method measures only a part of the informal economy because it neglects informally produced inputs by larger firms and irregular labour practices between them.

Ethnographic studies. Much of what we know about the informal economy at the level of individuals or geographically limited populations comes from ethnographic studies, where a few individuals or a group of people are studied intensely through intensive interviewing techniques, qualitative methods and case studies to determine what kinds of informal activities are done, who does them or why and when

people engage in informal economic activities. (Tickamyer and Wood, 1998, p. 324) These studies have produced rich sources of information on specific groups and places, but they are unfortunately limited when it comes to measuring the scope of informal activity in larger populations and geographic regions. Moreover, they are labour intensive, time consuming and expensive.

Direct survey methods, such as telephone surveys, in contrast to ethnographic studies, can produce a large data set representative of a diverse populations in a comparatively short period of time (Tickamyer and Wood, 1998, p. 326). In their article, Tickamyer and Wood (1998) discuss different survey techniques for collecting data on the informal economy. They argue that telephone surveys have several advantages over face to face surveys. For starters, the degree of anonymity is greater in a telephone survey. Furthermore, the well-known claim that open-ended questions are inherently better than closed-ended and more structured question formats must be reassessed. A complex issue like the informal economy benefits from carefully constructed and close-ended questions.

4. Approaching Informal Economic Activity in Toronto East

So far, we have tried to establish that the informal economy encompasses a wide range of activities, is multi-dimensional and far from being homogeneous. Such complexity calls for caution when it comes to either condemning or celebrating the informal economy. In other words, its multi-dimensionality calls for multi-dimensional approaches.

Critical perspectives, which make the case for informal economic activities being a survival strategy for the poor, view the informal economy as something hazardous to the economy and even to social order. Proponents, on the other hand, celebrate the informal economy as a salvation for the poor. While the relationship between social marginalization, impoverishment and the informal economy is strong, research has also shown that the majority of those participating in the informal economy are not necessarily poor but also includes those with skills, resources and the motivation to pursue extra “off the books” work. Clearly, too much focus on the poor can be misleading as it examines only one part of the informal economy. The informal economy exists at an intersection of various economic, social, political and cultural issues such as social exclusion, ethnic enclaves, immigrant integration and poverty, and it has both positive and negative impacts on both the economy and people’s lives.