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A Survey**

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## UNDERSTANDING THE "INFORMAL SECTOR": A SURVEY

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## UNDERSTANDING THE "INFORMAL SECTOR": A SURVEY

### 1 Introduction and overview

The term "informal sector" is today widely used in writings on both developing and developed countries. It is invoked to refer to street vendors in Bogota, shoe-shine workers in Calcutta, specialised knitwear makers in Modena and producers of fashion garments in New York City. What these activities appear to have in common is a mode of organisation different from the unit of production most familiar in economic theory, the firm or corporation. These activities are also likely to be unregulated by the state and excluded from standard economic accounts of national income. In this paper, I survey the literature on the "informal sector" in an attempt to understand the different applications of the term. I also wish to examine if it is possible and useful to arrive at a definition of the informal sector that can be applied to the different contexts, in the developing and developed world, in which the term is used. I shall argue that different aspects of regulation by the state provide the key to identifying an informal sector.

Research on activities encompassed by the term "informal sector" grew out of studies, in the fifties and sixties, on the dualistic nature of developing societies. The concept of dualism or a dual economy relates to various asymmetries in organisation and production, and dualism in the structure of an economy as between traditional and modern, peasant and capitalist sectors was considered to be a distinguishing characteristic of developing countries. Development was seen in terms of a shift from a traditional to a modern, an unorganised to an organised, a subsistence to a capitalist economy. Models of dualistic development recognised the interactions between the two sectors and

examined their implications for growth.<sup>1</sup> In this literature, the pre-capitalist or traditional economy was expected to decline in relation to the growing capitalist or modern economy. In general, these models assumed a diminishing of the prevailing asymmetries over time and a slow disappearance of dualism in the course of development.

The distinction between formal and informal activities emerged from the attempts of scholars to apply the dualism framework to labour markets in urban areas of developing countries. The emphasis on urban labour markets derived from dissatisfaction with development policies that were slow to trickle down and that left a large pool of visibly unemployed. Problems of urban unemployment and underemployment, of the working poor, of the large numbers of self-employed persons, were factors that motivated several studies on informal sector activities.<sup>2</sup>

A combination of factors has brought the informal sector into the mainstream discussion on economic development.<sup>3</sup> The term "informal sector" was able to incorporate activities that were earlier ignored in theoretical models of development and in national economic accounts into the discourse on development. As most activities in the informal sector are excluded from standard

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<sup>1</sup> On dualism and its implications in developing countries, see, for example, Lewis (1954), Jorgenson (1961), Fei and Ranis (1964), Harris and Todaro (1970), and Kanbur and McIntosh (1988).

<sup>2</sup> For example, ILO (1970); Joshi and Joshi (1976). The latter point out that "the problem of inadequate work and low productivity is concentrated par excellence in the unorganised sector" (*ibid.*:8).

<sup>3</sup> Two recent surveys that question the relevance of the term are Peattie (1987) and Sanyal (1988). Peattie argues that the adoption of the term "informal sector" obscures critical issues relating to poverty and Sanyal criticises the concept from the perspective of policy making.

measures of economic production,<sup>4</sup> Lisa Peattie argues that the term informal sector can be traced to the tradition of economic accounting in addition to that of dualism (Peattie, 1987).

Researchers of the formal-informal sector dichotomy have not assumed a steady decline of the informal sector over time and in the course of development. A job in the informal sector may either be viewed as a stepping stone to another in the formal sector or as a desirable end in itself. In other words, employment in the informal sector may be as remunerative as that in the formal sector.<sup>5</sup> Furthermore, the apparent resurgence of informal activities in developed countries contributes to the ambiguity about the role of the informal sector in the process of development.

The existence of an informal sector in the developed countries is compatible with important differences in the nature of informal activities across countries. Consider, for example, differences in the dynamism of informal enterprises as reflected in the difference between survival and growth of enterprises. Participants in many (though not all) informal activities in developing countries earn a bare minimum level of income,<sup>6</sup> and some of their enterprises survive times of crisis by relying on, and exploiting, family labour. In contrast, the small-scale informal sector in certain regions of some developed countries has shown a

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<sup>4</sup> However, this is not always the case. Attempts have been made in different Indian Censuses, for instance, to measure the contribution of household industries (see Basant and Kumar, 1990).

<sup>5</sup> And, moves from the formal sector to the informal sector cannot be ruled out.

<sup>6</sup> While there is a strong correlation between informal employment and poverty (e.g., Pardo *et al*, 1989: 101), all informal sector workers are not necessarily poor.

capacity for sustained growth and generation of high incomes. In the case of some regions in Italy, for instance, the high demand for specific skills has allowed certain homeworkers to earn as much as those working in large firms (Solinas, 1982). The extent to which the informal sector is able to generate a surplus and undertake accumulation is a crucial factor in determining the long-run evolution of the informal sector in both developed and developing countries.

Why study the informal sector? Although estimates of the size of the informal sector vary with the particular definition chosen, by most accounts, informal activities account for a sizable portion of the economy of developing countries. Here are some estimates.<sup>7</sup> In Egypt, when the informal sector was defined as comprising all self-employed workers and unpaid family workers, it accounted for 18 per cent of urban employment in 1976 (Hansen and Radwan, 1982). When informal employment was defined as that occurring in "small" establishments, the informal sector accounted for 50 per cent of Jakarta's urban employment in 1971, and 69 per cent of Brazil's urban employment in 1972 (Mazumdar, 1976).<sup>8</sup> Furthermore, there is evidence to suggest that the informal sector is expanding in certain regions. A United Nations study (PREALC, 1981) of employment in Latin American countries showed a rise in the share of employment in the informal sector, with informal employment defined as the sum of own account workers, unpaid family workers and domestic

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<sup>7</sup> All the estimates reported here use a direct survey-based approach to measurement of the informal sector rather than an indirect monetary approach.

<sup>8</sup> Even higher estimates for the size of the informal sector come from a recent study in Lima by De Soto (1989). For example, 91 per cent of the public transport fleet was estimated to be operated by an informal sector (*ibid.*:93). The estimation procedures used by De Soto and his group, however, have been criticised strongly (see Rossini and Thomas, 1990).

workers, in almost all countries (with the exception of Chile) between 1950 and 1980.<sup>9</sup>

The study of the informal sector also draws attention to the condition of women workers. A large number of women workers are employed in the informal sector and they constitute a significant proportion of all women workers (Menefee Singh and Kelles-Viitanen, 1987).<sup>10</sup> Estimates of women in the informal sector, however, are not very reliable as many women workers are engaged in home-based activities, that tend to be omitted from official records and statistics. Within the informal sector, it has been argued, women workers tend to be concentrated in low paid jobs (Bromley and Gerry, 1979). A study of the informal sector raises many issues such as that of earnings differentials and skill differentials between men and women in the informal sector.

There also appears to be what has been described as a "resurgence" of activities belonging to the informal sector in certain developed countries. Portes and Sassen-Koob (1987) argue that not only has the informal sector not disappeared in advanced countries, "on the contrary, [informal activity] seems to be growing, at least in some sectors" (*ibid.*: 41). They use three sources of data (for the U.S) to support their claim about the persistence of a small scale and informal sector in developed countries. First, based on aggregate monetary indicators they argue that the informal economy represented 10 per cent of measured GNP in 1978 (Gutmann, 1979, cited in Portes and

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<sup>9</sup> PREALC (1981), Dinamica del Subempleo en America Latina, Chile (reported in Portes and Benton, 1984: Table 1, p 593).

<sup>10</sup> In the Sixth Five Year Plan for 1980-85, for example, the Indian Planning Commission reported that 60 per cent of the rural female labour force and 44 per cent of the urban female labour force was in the self-employed sector.

Sassen-Koob, 1987).<sup>11</sup> Secondly, from data on the size of firms they find that the majority of the labour force was employed in relatively small establishments.<sup>12</sup> According to the US Bureau of the Census, about three-fourths of US establishments were very small, employing less than 10 workers, in both 1965 and 1983. Thirdly, they use case studies of specific regions, in particular the New York and Miami metropolitan areas, to infer a rise in the size of the informal sector.<sup>13</sup> There is also considerable evidence from European countries, Italy and Spain in particular, that supports the hypothesis of a growth in small-scale informal enterprises (Ybarra, 1989 and Capecchi, 1989). Even where there has been an absolute decline, traditional or informal enterprises, it is argued, still "represent a sizable mass" (Berger and Piore, 1980: 94, writing on France).

In spite of the growing recognition of the informal sector, there are disagreements about the definition and application of the term "informal sector". The different approaches to the informal sector surveyed in this paper can be organised as follows.

(1) Approaches that identify a formal-informal dualism on the basis of specific empirical characteristics of activities, characteristics that relate to the spheres of organisation, production and technology (section 2). This approach has been widely applied in studies of developing countries.

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<sup>11</sup> This estimate refers to the underground or hidden economy and is derived from discrepancies between aggregate monetary indicators.

<sup>12</sup> Excluding all public sector workers, Granovetter found that in 1981 one-fourth of private sector workers in the US worked in establishments with less than 20 persons (Granovetter, 1984). He found a similar and high proportion of workers in small enterprises in Sweden and Japan.

<sup>13</sup> See Stepick (1989) and Sassen-Koob (1989).



(2) Critical of the dualistic characterisation mentioned above, another set of views considers the informal sector to be a system of production closely related to and dependent on the rest of the (capitalist) economy (section 3). The economy is characterised as being fragmented with many interconnected sectors rather than as being divided into two distinct (formal and informal) sectors. The form of employment or the wage labour relation is considered important in demarcating different sectors.

(3) In the context of developed countries, small scale and informal enterprises have been associated with flexibility in technology and organisation including flexibility of labour use; this has been termed the 'flexible specialisation approach' (section 4).

(4) Lastly, a view that an absence of regulation and state recognition is the defining characteristic of the informal sector is one that is gaining ground (section 5). This approach has been applied to both developing and developed countries.

These four sets of views have several overlapping features but each set differs in the emphasis placed on different factors associated with an informal sector. Some of the confusion surrounding a definition of informal activity is cleared when a distinction is drawn between informal sector enterprises or establishments and informal employment; the two are related but not coterminous. There are three variables that recur frequently in the literature in definitions of an informal sector. These are (a) regulation by the state, (b) form of ownership and (c) the nature of employment. After examining these three factors, in section 6, I argue that only definitions based on certain aspects of regulation by the state provide an adequate demarcation of informal sector enterprises and employment.

## 2 Dualism in the urban economy: the ILO and other approaches

The International Labour Office (henceforth, ILO) adopted and popularised the term informal sector in a series of studies that focussed on the problems of employment in the urban areas of developing countries.<sup>14</sup> These studies were in response to the growth of large cities and mass unemployment in developing countries. The large increase in the urban labour force of many countries, a consequence of rapid population growth and urbanisation, was often not absorbed by the growth in employment and many workers, in particular migrants, turned to other activities to earn meagre incomes.<sup>15</sup> These activities, which were often characterised by self employment, constituted the core of the informal sector. Self-employed workers were engaged in a range of activities including trade, services, transport and manufacturing. Although the term "informal" had been used earlier, (in the literature on rural credit, for example)<sup>16</sup> the ILO borrowed the term from a study of urban labour markets in Ghana by Keith Hart. Hart distinguished formal and informal income opportunities on the basis of whether the activity entailed wage or self-employment (Hart, 1973).

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<sup>14</sup> Among the many studies undertaken by the ILO, the early Mission to Kenya (ILO, 1972) was important in formulating the concept of the informal sector.

<sup>15</sup> Joshi and Joshi, for example, write that "a very important manifestation of the employment problem is the phenomenon of the working poor, who may perform a great deal of work of very low productivity" (Joshi and Joshi, 1976: 6). Again, "those who fail to secure employment in the modern, organised sector are forced into the unorganised sector which has the capacity to absorb them either as casual labour, low wage employees in small enterprises, or as self-employed or family workers" (*ibid.*). Also see Hofmann (1986).

<sup>16</sup> See, e.g., Nisbet (1967).

While it was recognised that most informal enterprises were unenumerated and unregulated by the state, this was not considered a necessary feature of informal sector enterprises. Nattrass (1987), for instance, gives an example of a small-scale labour-intensive petty producer operating with a license. Furthermore, the ILO recommended government interventions that would assist informal activities that were unregulated and unprotected by such means as providing cheap credit and training workers.<sup>17</sup>

In order to define a target group for government action aimed at promoting employment-oriented development, the ILO specified a set of characteristics of informal enterprises. These were:

- (1) small scale of operation;
- (2) family ownership;
- (3) reliance on indigenous resources;
- (4) labour intensive activity, technology adapted to local conditions;
- (5) skills acquired outside the formal school system;
- (6) ease of entry into the activity; and
- (7) operation in unregulated, competitive markets.

These are essentially features of organisation and technology, which, it is suggested, distinguish informal enterprises from formal ones. The emphasis, however, appears to have been placed on the organisational structure of a unit of production rather than its technology.<sup>18</sup> This is

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<sup>17</sup> It is worth noting that unregulated enterprises were not seen as benefiting from the fact of non-regulation. This contrasts with later studies (such as by De Soto) which view regulation as the main constraint on the growth of informal activities.

<sup>18</sup> For example, S. V. Sethuraman of the ILO states that the informal-formal distinction is different from the traditional-modern distinction in that the latter was based (primarily) on technology (Sethuraman, 1976).

formalised in models such as that of Datta Chaudhuri (1989) where technology is identical across the two sectors.

It is useful to compare this concept of the "informal sector" with the conventional meaning of a "sector". In Simon Kuznets' formulation, "sectors within the production structure of a country's economy can be distinguished because they produce different goods by processes that differ in technology and organisation" (Kuznets, 1971: 99, my emphasis).<sup>19</sup> It should be noted that the distinction between formal and informal sectors in the ILO approach is not based on characteristics of products, production processes and technology. The same goods and services, and perhaps even the same technology, may be found in both formal and informal sectors.

A similar but more detailed list of characteristics distinguishing formal from informal enterprises or what he termed the upper and lower circuits of an economy was presented by Santos (1979). The characteristics covered the spheres of organisation, technology, relations of enterprises with governments and other institutions such as banks, and the nature of product and factor markets.

In an early study on surplus labour in the cities of developing countries, Joshi and Joshi (1976) distinguished between organised and unorganised activities on the basis of (a) market structure, (b) technology, and (c) relationship

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<sup>19</sup> Kuznets goes on to say that "(the) finished products may differ with respect to durability, priority of need they satisfy, responsiveness to changing economic levels, degree of complementarity with other products and supply conditions. Unfinished products may differ in distance from the finished products and in the character of the finished products they enter.... An extremely wide variety of sectors can be distinguished by a combination of characteristics of output and production processes" (Kuznets, 1971: 99).

with government.<sup>20</sup> Unorganised or informal activities were defined as those using an indigenous and labour-intensive technology, operating in competitive markets and having no relation with government. By contrast, the organised sector typically comprised large firms operating in oligopolistic markets, with capital intensive technology, a protected work force, and enjoying access to government. This approach is similar to that of the ILO studies but introduces the absence of intervention by the state as an explicit feature of informal activities.

The above mentioned approaches have resulted in a large number of operational definitions, varying with the context. The informal sector has been defined as a sector comprising "enterprises operating out of a temporary physical structure" (House, 1984), and as a sector comprising unskilled workers, skilled manual workers and handicraftsmen (Dasgupta, 1973).<sup>21</sup> It has been defined as a sector that includes "small-scale wholly African owned enterprises employing not more than 10 persons" (Aryee, 1976), as a sector consisting of "self-employed [persons] with less than 13 years of schooling" (Terrell, 1976) and as a sector of "small-scale enterprises whose labour input is predominantly provided by relatives of the owner" (ILO, 1976, cited in Breman, 1976). In a study of Fayoum city in Egypt, the informal sector was defined as a "community of traditional artisans and traders, small in scale and bound to a long-established range of goods and services" (Hofmann, 1986). Another operational definition of the informal sector used the criterion of "non-occurrence of fixed hours or days of

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<sup>20</sup> Joshi and Joshi (1976), pp 44-46.

<sup>21</sup> Participants of the informal sector also display a wide range of skills and include artisans and craftspersons who possess specialised skills. In some countries, the contribution of craftspersons to national income and exports has been quite high. See Pye (1988) on the Asian experience.

operation" (Sethuraman, 1976: 81) to identify enterprises. Given the heterogeneity of activities in the informal sector, different empirical characterisations are inevitable.<sup>22</sup>

The ILO studies have succeeded in calling attention to a neglected part of the economy of developing countries. They have also highlighted the empirical diversity of activities and enterprises that come under the general rubric of the term "informal sector". At the same time, there is an arbitrariness in the choice of features that demarcate the "informal sector". Case studies of informal activities show important exceptions to each of the seven features specified by the ILO (listed on p 9). Gerry, for instance, shows that entry into informal activities can be quite selective and competitive rather than easy and that many small enterprises depend on imported rather than indigenous goods (Gerry, 1974).<sup>23</sup> Family-owned enterprises often employ non-family labour. It is also difficult to arrive at a definition of a small-scale enterprise.<sup>24</sup> It could be defined, for example, on the basis of number of workers, capital stock, turnover or energy consumption. These indices could be misleading, at times, as when a group of small firms is controlled, or indirectly owned, by a large firm. Furthermore, the specified characteristics may not always be compatible with each other. When an enterprise is not owned by his family, to take an instance, entry into the occupation may be quite difficult for a worker (Joshi, 1980). This range of operational definitions of the informal sector deriving from the ILO approach needs to be demarcated

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<sup>22</sup> See, also, the case studies sponsored by the ILO in Sethuraman (eds.) 1981.

<sup>23</sup> Also see Nakanishi (1990).

<sup>24</sup> See, e.g., the discussion on the meaning of "small" in Bannerjee (1981).

firmly from the basic analytical distinctions between the two sectors that is taken up in section 6.

An approach similar to that adopted by the ILO has been used by some scholars in developed countries too. Berndt (1976) in a study based in Detroit, Michigan, identified the informal sector in terms of factors such as the scale of production, level of capital investment, organisation of labour and institutional protection. In her study of informal sector activities, Berndt attempted to show the role played by informal activities in developed countries in providing specialised goods and services.<sup>25</sup>

### **3 Sectoral dependencies and interlinkages**

In contradistinction to the ILO approach, some researchers have stressed the complementarities, continuities and linkages between formal and informal sectors rather than their separateness.<sup>26</sup> Breman, for instance, argues against adopting a dualistic or compartmentalised view of the labour market, and instead suggests that the labour market be viewed as "fragmented", on the ground that the distinctions between formal and informal sectors are more noticeable at the poles (Breman, 1976 and 1977). The informal sector is characterised as being dependent and subordinate to the capitalist sector, with the capitalist or formal sector exploiting the informal

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<sup>25</sup> Berndt also proposed a typology of activities within the informal sector based on the nature of "relationships" entered into by participants. The four aspects of a relationship considered by her were: (i) agent: kin, friend, person institutionally related, anonymous agent (market); (ii) form of exchange: monetised or non-monetised; (iii) duration of exchange: bounded or open-ended; and (iv) terms of exchange: specified or flexible.

<sup>26</sup> See for example, Biderman (not dated), Breman (1976, 1977), Bromley (1978), Davies (1979), Moser (1978 and 1984) and the readings in Bromley and Gerry (1979).

sector by obtaining cheap labour and wage goods. Bromley argues that informal enterprises are not "independent, unorganised, ... little related to the authorities or big business..." (Bromley, 1978: 1161) as suggested by the ILO studies but have important links with the formal sector. In his study of street traders in Cali, Colombia, he found that a large number of traders fell into "potentially exploitative working relationships with large enterprises" (*ibid.*).<sup>27</sup> It has also been argued that "self employment" is a catch-all term that often hides relations of dependence, as for example, among sub-contractors and commission sellers who, it is argued, can be considered disguised wage workers.<sup>28</sup> If relations of dependence and the absence of security of work and income are of concern then a preoccupation with the self-employed is understandable (Bremner, 1977).

Critics of the dualistic approach have provided an alternative formulation of the informal sector based on petty commodity production, that is concomitant with, and subordinate to, capitalist production (Moser, 1978). A majority of petty commodity producers are considered to be part of the informal sector. Moser's approach also recognises a continuum of economic activities rather than a two sector distinction. So, "workers are seen to be employed in a number of different categories outside the well defined wage sector of large-scale enterprises" (*ibid.*: 1056). These include, among others, wage workers in small enterprises,

<sup>27</sup> This is in contrast to Sethuraman and others who viewed the linkages between the two sectors as benign rather than exploitative.

<sup>28</sup> McEwan Scott (1979) and Gerry and Bromley (1979) argue that the independence inherent in the term self-employment (i.e. ownership of means of production by direct producer) is often absent in the case of certain household workers who undertake piece work for large manufacturers. Nevertheless, it is worth distinguishing between the categories of self-employed workers and regular wage workers.



self employed persons, unpaid family workers and casual workers in the wage sector. Here, the form of employment or the wage labour relation is considered an important feature demarcating the different but inter-connected sectors of an economy.

The importance of interdependencies between sectors is also reflected in the Latin American discussion on marginality, a term used to refer to the urban poor in general, and to those not integrated economically or socially into society. Marginality is considered to be a consequence of a pattern of uneven and dependent development of an economy on the periphery that is dependent on economies of the centre.<sup>29</sup>

The views discussed in this section emphasize the links between enterprises in the formal and informal sectors and argue against viewing the "informal sector" in isolation. Links with the capitalist or formal sector, it is argued, set crucial constraints on the potential growth of small enterprises and petty commodity producers. Policies for raising incomes and employment among petty producers, therefore, would need to take account of the structure of an industry as a whole (Moser, 1978).

#### **4 Flexible contracts: the developed country experience**

The growing literature on "flexible specialisation" in developed countries has also focussed attention on small-scale enterprises. Flexible specialisation refers to the development of a specialised and small scale system of production that exhibits flexibility in production in contrast to the relatively rigid and large scale, mass production factory system. In The Second Industrial Divide,

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<sup>29</sup> See, e.g., Perlman (1976) and Kowarick (1979).

Piore and Sabel sketch the recent growth of small production in the craft tradition, with flexible specialisation -- a combination of flexible technology and specialised production -- in several developed countries, notably Italy, Germany and Japan (Piore and Sabel, 1984). This development is linked to the economic crisis that has affected the industrialised countries in the seventies and eighties. The emergence of highly specialised small firms is seen as a response to changing market conditions, in particular greater fluctuations in demand, and the requirements of specialised production in short cycles. On the supply side, technological advances in electronics and computer technology have helped by increasing the potential flexibility of capital and generating flexible production techniques.<sup>30</sup> Other factors that contributed to the rise of small firms include changes in the nature of the labour force, such as greater disutility from repetitive work, the specialisation and diversification of demand, and the increased capacity of developing countries to make standardised products.<sup>31</sup>

Flexibility in this model refers to several aspects of production and organisation including flexible technology (e.g. multipurpose machines), workers with a wide range of skills and flexible firms (producing a range of products). Flexibility is also a characteristic of the labour market given the "small enterprises' power to make workers redundant whenever they want" (Brusco, 1982: 177).<sup>32</sup> In

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<sup>30</sup> It should be noted that the flexible specialisation approach is associated with "technological sophistication rather than regression to simple techniques" (Piore and Sabel, 1984: 207).

<sup>31</sup> For a summary of factors contributing to the growth of small enterprises in Italy, see Barca (1989) and Benton (1990).

<sup>32</sup> The importance of flexible labour contracts is widely recognised. Brusco, for example, writes that the "role of the (secondary or small-scale) sector is to return (in

other words, the system's flexibility in shifting output quickly comes from the power of small firms to hire and fire workers as needed. If small enterprises in developed countries and "informal" activities in developing countries have some features in common, they relate to this flexibility of labour use and the associated nature of labour contracts.

The model of flexible specialisation is also associated with a particular system of regulation. In particular, it requires a regulatory framework at the microeconomic level that can initiate and coordinate innovation. This is possible through different forms of institutional cooperation such as those found in certain industrial districts of central and northern Italy. The absence of an appropriate system of regulation could lead to technological stagnation, and conflict rather than cooperation between small producers. The research on flexible specialisation in small-scale production has highlighted the comparative advantage of small firms and shown that they have the potential for technological dynamism and high growth.<sup>33</sup> The capacity for accumulation is a noteworthy feature of the small scale sector in this model.

The negative aspects of small-scale production should not, however, be ignored. Writing about the fashion industry in New York, Waldinger points out that the particular conditions of demand -- seasonality and specialised

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periods of expansion) flexibility in the use of labour to the entire productive structure" (Brusco, 1982: 183).

<sup>33</sup> Benton (1990) examines the conditions associated with the dynamism of decentralised production in Italy and explains why these conditions are not easy to replicate in other countries. For example, an important ingredient of the success of small enterprises was the political context and the cooperation among artisans, workers, small business men and local government officials within Communist-led municipalities in central Italy.

production -- for garments have resulted in a high turnover of labour, use of immigrant cheap labour and a return of the sweatshop (Waldinger, 1978).<sup>34</sup> Growing wage inequality in the United States, measured in terms of average weekly earnings, has also been attributed to changes in the organisational structure of industry, and to an increase in labour market flexibility (Harrison and Bluestone, 1990). In many cases, an expansion of informal production has led to a deterioration in working conditions.

The unpleasant side of small enterprises is brought out vividly by Ybarra in a study of the footwear, textiles and toy industries of Valencia, Spain (Ybarra, 1989). In these three sectors, informal production accounted for over a third of total production.<sup>35</sup> The negative consequences of the growth in small enterprises included a worsening of labour conditions and a decline in wages. Workers in the household were found to suffer physical and psychological risks from the type of work performed and the unsatisfactory work place. Apart from unsanitary conditions of work, workers often handled toxic substances without safeguards. The sub-contracting of work has resulted in the use of low-skill processes. Ybarra argues that informalisation has led to the "elimination of incentives for technological progress, innovation and investment" (ibid.: 225).

In conclusion, the small-scale sector in developed countries has certain features of organisation and labour use that are similar to those found in the informal sector of developing countries. While the small-scale sector cannot

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<sup>34</sup> Sassen-Koob (1989) documents the growth of sweatshops, subcontracting and use of home workers in New York city as does Stepick (1989) for Miami.

<sup>35</sup> Informal production is here defined as production or exchange of goods and services conducted at the margins of official and administrative regulations (Ybarra, 1989: 217).

be viewed in isolation from the rest of the economy, nevertheless, there are some useful lessons to be learnt from a comparative study across countries. The technological dynamism of small-scale enterprises in certain industries in developed countries, for instance, offers useful guidelines for a discussion of the potentiality (in terms of technological innovation and accumulation) of informal activities in developing countries.<sup>36</sup> Another lesson for developing countries, from the experience of the small-scale sector in Italy or Germany, is that their strength derives from clustering and the economies of agglomeration (Schmitz, 1988).<sup>37</sup> At the same time, an expansion in small scale production is often associated with backward features of employment such as bad working conditions and exploited labour, that should not be ignored; they should serve as a warning against an unqualified promotion of small scale enterprises.

## **5 Regulation as the defining feature of the informal sector**

The view that "informal" activities are those that are unregulated by the state, and are outside the boundaries of legally sanctioned activities, has been gaining considerable ground in recent studies undertaken in both developing and developed countries. According to Weeks, for instance, "the

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<sup>36</sup> This is not to imply that a simple extension of theories such as the flexible specialisation approach to the developing country context is possible. The existence of surplus labour in developing countries, for instance, is a structural constraint that prevents a simple extension. The effect of surplus labour is to trap producers in low income, low technology situations. By contrast, a tight labour market has very different consequences for technological change in an industry (Schmitz, 1988, Solinas, 1982 and Tendler, 1987).

<sup>37</sup> However, as noted in a study of small enterprises in Punjab, it is not clustering alone that generates benefits but the nature of relationships among producers (Tewari, 1990).

structural position of an economic operator", by which he means whether or not the operator is "officially recognised, fostered, nurtured and regulated by the state" (Weeks, 1975: 3) is the defining characteristic of informal enterprises. While most studies of the informal sector noted the absence of legal regulation, this was not emphasised in some of the views discussed earlier. In this section, I shall examine approaches that give state regulation a central role in defining the informal sector.

Before proceeding further, it needs to be pointed out that regulation in this paper is used as in the english meaning of the term, and refers to specific rules and regulations imposed by the state on economic activities. It should not be confused with regulation as defined by the French regulation school. To study the regularities in economic development and the crises which occur within these regularities, theorists of the French regulation school have put forward the concepts of a regime of accumulation and a mode of regulation. A combination of the two defines a mode of development. A mode of regulation refers to a "set of processes which govern the allocation of factors of production, their utilization, and the division of income" (Benassy, 1977; cited in Boyer, 1990). In the usage of the French school, regulation refers to the entire system of laws and procedures that determine the way in which a society is reproduced. A theory of social regulation is viewed as "a complete alternative to the theory of general equilibrium" (Aglietta, 1982; cited in Boyer, 1990). In this paper, the term regulation is not tied to an overarching concept of a "mode of regulation".<sup>38</sup>

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<sup>38</sup> It should be pointed out that the writings of the regulation school have influenced some of the contributors to the literature on the informal sector.

In his work on urban labour markets in developing countries, Dipak Mazumdar distinguished between the formal and the informal sectors by the presence of labour legislation in the case of the former. He termed the formal sector as the "protected" sector, one wherein employment was protected by actions of governments or trade unions or both (Mazumdar, 1976). The informal sector, according to Mazumdar, comprised workers excluded by labour legislation. There have been many different versions of this approach.<sup>39</sup>

The growing literature on the "informal sector" in developed countries also emphasizes the relations of participants in informal activities to the state. In a paper on "informal" activities in developed countries, Portes and Sassen-Koob define the informal sector as the "sum total of all income-earning activities with the exclusion of those that involve contractual and legally regulated employment" (Portes and Sassen-Koob, 1987: 31).<sup>40</sup> More broadly, the informal sector has been defined as "a specific form of income generating production...unregulated by the institutions of society in a legal and social environment in which similar activities are regulated" (Castells and Portes, 1989: 15). In this particular definition, note that regulation is not the task of the state alone but also of society, and could be interpreted as including regulation by custom. Regulation can also be undertaken at different levels of government (such as by the national government, state or provincial government and local government). If the

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<sup>39</sup> Arias and Roberts, for example, in their study of Guadalajara, Mexico, adopt this approach and argue that the informal sector gains its comparative advantage (lower costs) from this very lack of regulation by the state (Arias and Roberts, 1985). See also Amin (1987).

<sup>40</sup> Portes and Walton (1989) argue that this definition encompasses a wider set of activities in the informal sector than a definition based on petty commodity production (as in section 3).

informal sector is defined by the absence of regulation, there is a need to specify the type of regulation that the unit under consideration is excluded from (see Section 6).

For those defining the informal sector in terms of regulation, the organisational character of enterprises is relegated to a minor role. As Castells and Portes write, "the informal economy does not result from the intrinsic characteristics of activities but from the social definition of state intervention" (ibid.: 32).

While the absence of regulation in the sense of specific rules has been used as a criterion for defining the informal sector in both developing and developed countries, a divergence between the two groups of countries is likely with respect to the origins of the informal sector. This is because some small-scale informal enterprises may be created in order to evade tax and labour laws and so derive from specific types of regulation, while others may be the product of historical circumstances and unrelated to the extent of state regulation. A major factor in the growth of the informal garment industry in New York, for example, is considered to be the evasion of regulations covering taxes, health and safety, minimum wage laws (Sassen-Koob, 1989). The growth of street vendors in Nairobi or Manila, however, is more likely to be based on poverty and the need for survival, on the lack of employment opportunities elsewhere, than on avoidance of regulations imposed on merchants in the formal sector.

In The Other Path, Hernando de Soto defines the informal sector as "the refuge of individuals who find that the costs of abiding by existing laws in the pursuit of legitimate economic objectives exceed the benefits" (De Soto, 1989: xxii). This definition highlights a causal factor that is believed to underly the growth of the



informal sector, namely government rules and regulations. From his study of the informal sector in Peru, De Soto concludes that state intervention and regulation hinder the development of enterprises and so calls for a new kind of legal system, one that promotes "economic efficiency". De Soto views enterprises in the informal sector as being creative and operating under healthy competition. Efficient laws are necessary, he writes, "in order to free and increase the vendors' entrepreneurial energies, and to allow them, within the competitive process in which they are immersed, to use their talents to the full" (*ibid.*: 91-2). To allow informal activities to develop their full potential, De Soto calls for greater private property rights and less state intervention. Although there are genuine problems created by excessive bureaucratisation, and badly designed laws may impede development, it does not follow that remedying the legal system is sufficient to promote economic development.<sup>41</sup> This approach also ignores the positive role of public intervention in the development of small-scale production. As discussed earlier, the view of the informal sector as "competitive" can also be questioned. Judith Tendler, for example, points out that many informal enterprises are characterised by cooperation rather than competition, and that De Soto's own evidence supports the view of cooperation among informal enterprises (Tendler, 1987: 14).

The De Soto view and that of certain other Latin American writers (e.g. Guissari, 1989) can be interpreted as a populist version of the neoclassical "getting prices right" approach.<sup>42</sup> It has been argued that small-scale enterprises in developing countries have the "right" factor

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<sup>41</sup> See Thorp (1990) on this and other flaws in De Soto's argument.

<sup>42</sup> See Tendler (1987).

proportions as they use more cheap labour and less expensive capital. The case for the small-scale sector is based on the assumption that it is in some sense more efficient.<sup>43</sup> The problem of unemployment too is viewed as a result of distortions or artificially maintained low prices for capital (e.g. through cheap credit) and high prices for labour (e.g. through unionisation, labour legislation). On these grounds, the policy recommended by these writers is less regulation (particularly of labour markets).

An important counter-example comes from Italy where some of the most successful small enterprises have benefited from state intervention.<sup>44</sup> Local governments aided small enterprises by providing credit, equipment and social services.<sup>45</sup> The interventions of public institutions that provided services such as daycare centres at little or no cost were important for the growth of small enterprises. There is thus evidence for "a supportive relationship between the official and informal economies" (Capecchi, 1989: 212).<sup>46</sup>

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<sup>43</sup> The implications of this view and their validity are examined in detail by Little, Mazumdar and Page (1987). They conclude that there is no significant relationship between firm size and technical efficiency or factor productivity (ibid.: 309).

<sup>44</sup> A recent study of small producers in Ludhiana district of Punjab also points to the important role played by the state at critical junctures in the development of an industry (Tewari, 1990).

<sup>45</sup> See, e.g., Piore and Sabel (1984), Capecchi (1989).

<sup>46</sup> The informal economy refers to the small scale sector characterised by flexible specialisation. Both the sale of labour and of output are often informal in this sector (Capecchi, 1989).

## 6 Some definitional issues

This brief survey of the literature illustrated the range of activities and enterprises that have on different occasions been accommodated under the rubric of the "informal sector". In this section, some general criteria for demarcating formal and informal sectors are set out without attempting to achieve a demarcation of the precise boundary between the two.

At least a part of the ambiguity in the literature on the informal sector stems from the failure to make a clear distinction between informal sector enterprises and informal sector employment. The term "informal sector" usually refers to either enterprises or employment or both of them; the two may overlap but do not always coincide. Empirically, when an enterprise is in the informal sector then the workers in that enterprise also belong to what can be termed informal sector employment. The reverse, however, is not always true. It becomes easier to define the informal sector when a distinction between enterprises and employment is introduced.

Of the many characteristics used to identify the informal sector, the following three features of an activity recur frequently in the literature. These are: (a) regulation by the state, (b) forms of ownership and (c) the nature of employment. In this section, I examine descriptions of the informal sector, as applied to enterprises and employment, based on these three variables.

Let us first consider definitions of enterprises in the informal sector. One approach is based on regulation of an enterprise where regulation denotes the active intervention of the state in the operation of economic activities by means of enforceable legal rules. Informal sector

enterprises can be defined as comprising establishments whose existence or status is not regulated. Here, regulation of the status of an enterprise refers to licensing i.e., obtaining a permit from authority or registration. With this definition, the informal sector comprises all unregistered and unlicensed enterprises.<sup>47</sup> The absence of regulation of the status of an enterprise is sufficient to classify that enterprise as belonging to the informal sector.

Informal sector enterprises have also been defined in terms of the form of ownership of an enterprise. Among the many possible forms of ownership, informal sector enterprises are characterised by self-ownership and family ownership. The fact of self-ownership or family ownership, however, is not sufficient to classify an enterprise as belonging to the informal sector. A family-owned large factory, for example, would not be included in the informal sector. The nature of ownership when combined with certain types of regulation can, of course, be used to identify enterprises in the informal sector.

Secondly, let us turn to definitions of informal sector employment. It is possible to define informal employment in terms of the extent of regulation of employment conditions. Informal sector employment occurs in circumstances where the labour process and the conditions of work are outside the sphere of public scrutiny.<sup>48</sup> Regulation of the labour process can be implemented through regulation of a

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<sup>47</sup> In empirical work (and particularly that related to policy issues), it may also be useful to distinguish between those unregistered activities that are legitimate, in the sense that the same activities also occur in the regulated world, and others that are not. An example of the former could be the textile industry where some production units are registered and some are not; an example of the latter would be unregulated sales of drugs.

<sup>48</sup> Absence of regulation can, of course, arise both from exemption and evasion.

formalised labour contract, that includes specifications of wages and job security. Regulation of working conditions entails regulation of sanitary and health conditions in the work place, specification of safety regulations, and so on. Workers who are employed on contracts that are not under the purview of the state comprise the category of informal employment.<sup>49</sup>

Note, however, that there are many subcategories of labour legislation that fall under the heading "regulation of employment", and different researchers may pick on different criteria to demarcate the informal sector. This leads to a set of definitions of informal employment that depend on the aspects of labour legislation that are selected for demarcating the two sectors. An absence of all forms of labour legislation is one possible characterisation of informal employment. A weakening of this definition to a condition of partial absence of regulation of employment conditions, e.g., regulation of wages, will naturally shift the boundary between formal and informal employment.

In contexts where there are no labour laws or where labour legislation is not well specified, informal employment will have to be defined in a different way. The more ambiguous the legislation on labour, the less well defined is the border between formal and informal employment.<sup>50</sup>

Formal and informal employment have also been distinguished by the specific form that employment takes.

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<sup>49</sup> Note that with this approach, employment in agriculture in developing countries is also included in informal employment.

<sup>50</sup> Fernandez-Kelly and Garcia (1989), for instance, show how enterprises make use of ambiguities in legislation and conflicting interpretations of laws by state and federal agencies.

Consider the following three forms of employment: self-employment, family labour, and hired labour. Within hired labour, a further sub-division, between casual and stable hired labour is useful in this context. The category termed stable hired labour refers to the employment of workers on regular contracts, entered into in advance, that specify job content, and the conditions of work and payment for a job. These are contracts that are regulated by the state and provide a certain measure of job security. By contrast, casual labour is associated with ad hoc, often short-run employment, on contracts that are not fully specified, that are often verbal and characterised by terms and conditions of employment that are variable.<sup>51</sup> In the latter case, the relations between employer and employee tends to be of a personalised nature. Notably, stable hired labour is distinguished from casual hired labour by state regulation of a formalised labour contract.

Employment in the informal sector has been defined as comprising self-employed workers, family workers and casual labourers.<sup>52</sup> As noted above, casual labourers are identified by the absence of a formalised labour contract and regulation of employment conditions. Furthermore, from among self-employed workers and family workers, clearly, only those workers with employment contracts and working conditions that are unregulated by the state belong to the category of informal employment. So a definition of informal employment based on forms of employment can be improved upon by specifying the extent of regulation of labour.

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<sup>51</sup> Close parallels can be found in the discussion in contract theory on transactional versus relational contracts and fixed versus flexible contracts. See, e.g., MacNeil (1974 and 1978) and Williamson (1979).

<sup>52</sup> See, e.g., Diez de Medina and Gerstenfeld (1986).

To recapitulate, it was argued that informal sector enterprises could be identified by an absence of regulation of the status of an enterprise. A specification in terms of the pattern of ownership of an enterprise was found to be inadequate to identify enterprises belonging to the informal sector. An absence of regulation of employment conditions was used to define informal employment. Definitions based on the form of employment such as self employment were also shown to be inadequate characterisations of informal employment. An exception to this is the distinction based on casual labour versus stable hired labour which corresponds directly to differences in the regulation of labour contracts.

The two categories of the informal sector -- informal enterprises and informal employment -- and the two types of regulation are, of course, inter-related although not in a symmetric way. The absence of registration implies the absence of labour legislation. So, workers in an informal enterprise belong to the category of informal employment.

Let us consider some of the definitions surveyed earlier in the paper and see how they relate to the approach proposed in this section. Bromley and Gerry (1979) characterised the informal sector as comprising casual workers, sub-contractors and other self-employed persons. A lack of regulation of employment contracts appears implicitly in the above formulation and needs to be made explicit to arrive at a demarcation of informal sector employment. Self-employed workers who are covered by labour legislation, for instance, would not then be classified within the informal sector. The ILO characterisation of the informal sector in terms of ownership and employment variables, e.g., as comprising self-employed workers and (small scale) family-owned enterprises, (a) conflates informal sector enterprises with informal sector employment,

and (b) is inadequate to identify either informal enterprises or employment without further specification of the nature of state intervention.

To sum up, I have argued that in analytical terms, the only approach to defining informal sector enterprises and employment that stands up to close scrutiny is that based on certain types of regulation. This does not, however, preclude the use of a larger set of operational characterisations in empirical work. Take, for instance, the use of scale to identify informal sector enterprises. Scale may be a good proxy for certain aspects of regulation and forms of employment. Small enterprises tend to be characterised by less regulation. Labour inspectors, for example, may only be required to supervise units with a certain minimum number of workers. Depending on the context, other proxy variables could be used to identify enterprises and employment in the informal sector.

## **7 Concluding remarks**

This survey of the literature revealed a variety of meanings given to the term informal sector. A failure to distinguish between enterprises and employment, it was argued, led to ambiguities in definitions of the informal sector. I examined three features of an activity that were commonly used to define the informal sector, namely, forms of employment, forms of ownership and types of regulation. Of these, only definitions based on the regulation of the status of an enterprise and regulation of employment conditions proved to be adequate conditions for identifying informal sector enterprises and employment respectively.

Whatever the operational definition adopted, it appears that informal sector employment accounts for a significant share of employment, urban and rural, in developing



countries. In the developed economies, in recent years, research on the existence of informal sector employment has grown rapidly.

While the precise boundary between formal and informal sectors is often difficult to draw, the two sectors are clearly distinct. Furthermore, they are not isolated: numerous links between enterprises in the formal and informal sectors were noted including, for instance, the sub-contracting of work by formal enterprises to informal enterprises. In the presence of such links, to be effective, public policies targeted at the informal sector must examine the implications of a selected strategy for the formal sector, and vice versa.

A return to the contrasting motivations underlying the study of the informal sector in developing and developed countries provides a perspective on the relevance of discussions of the informal sector. In developing countries, research on the informal sector derived from a concern with the problems of mass poverty and unemployment. Work in the informal sector was identified with low productivity and low incomes. The discussion focussed on the large numbers of poor self-employed workers in urban areas of developing countries. Today, the existence of huge reserves of underemployed and unemployed workers -- workers with low skills and low productivity, and workers living in poverty -- remains the primary motivation for studying the informal sector and its evolution. To find solutions to these problems, we do require a clearer understanding of the activities that such workers are engaged in and their links with the wider economy.

In the developed world, a concern with the growing economic crisis and the re-emergence of sweatshops and cheap labour has fuelled the debate on informal enterprises and

employment. The continued existence, and resurgence, of small scale production in developed countries calls for a radical rethinking of the processes and paths of development. An assessment of the small scale sector must take account both of the dynamic and forward-looking aspects of such activity such as matching production to variable demand and the use of modern technology, and the backward features of production such as the return of the sweatshops.

An important issue that was referred to briefly at different points in the paper relates to the extent of surplus generated by the informal sector or, to put it differently, the possibility for accumulation within the informal sector. The ILO approach to the informal sector, for instance, implicitly assumed that informal enterprises had low levels of capital, if any, and failed to generate a surplus. (Surplus refers to the extent of benefits generated above that necessary to maintain the worker and his family.)<sup>53</sup> Some of the radical critics of the ILO view have argued that the formal sector appropriates the surplus generated by the informal sector. In contrast to studies of the informal sector in developing countries, some of the research in developed countries has shown that under certain circumstances, there are possibilities for accumulation within the informal sector.

The informal sector is also beginning to be incorporated in multi-sectoral models of growth where constraints to the expansion of the informal sector can be introduced in a specific way.<sup>54</sup> It is thus possible to examine conditions under which the informal sector can accumulate and grow (Gibson and Kelley, 1991). This is an

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<sup>53</sup> There are, of course, problems in defining and measuring surplus in cases such as those of self-employed artisans.

<sup>54</sup> For example, Datta Chaudhuri (1989), Gibson (1991), Gibson and Kelley (1991) and Rao (1990).

important area of research with implications for policies towards the informal sector.

In a second part to this paper, some of the issues discussed here will be examined in the context of a specific case from the developing world. I propose to focus on a single activity or sector of production in India by means of which the nature of formal and informal enterprises and employment and the relations between them can be illustrated.

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