Avoiding Informality Traps

By

Ravi Kanbur[*]
www.kanbur.dyson.cornell.edu

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Abstract

Despite historically high rates of economic growth in South Asia over the last two decades, the extent of informality remains large and widespread. This paper asks why that is, why informality needs to be addressed, and how it can be addressed. The central thrust of this paper is to emphasize the heterogeneity of the informality discourse. While informality has a core commonality of concern in analysis and policy, there are diverse conceptualizations, diverse empirical measurements, diverse causal channels and theories of informality, and diverse policy concerns. For policy, the single most important conclusion is that there is no single overarching policy intervention to address the concerns that arise with informality, and that a range of interventions need to be examined and implemented. These include: policies that induce fast growth whose sectoral patterns make it highly labor absorbing; extending coverage of state protections to informal workers while reviewing existing regulations to enhance their flexibility and implementation; direct measures to increase the productivity and incomes of enterprises in the informal sector, which includes targeted measures of training and enterprise support as well as general measures of bringing legal and other state infrastructure support to these enterprises; better enforcement of regulations that do exist, and assessing enforcement possibilities before regulations are passed.

[*] Cornell University: T.H. Lee Professor of World Affairs, International Professor of Applied Economics and Management, and Professor of Economics. Paper written for forthcoming volume, Ejaz Ghani (Editor), *Reshaping Tomorrow: Positioning South Asia for the Big Leap*.

1. Introduction

There seems to be a consensus in the development economics and development policy discourse that "informality" is "bad". It is bad for economic growth, for equity, and for poverty reduction. But varied reasons are given as to why informality is bad. This relates of course to the different ways in which informality is conceptualized and operationalized, as well as to the precise definition of "bad". Differing conceptualizations, and differing objective functions, lead to varied diagnosis of why informality is a trap, and thence to varied policy prescriptions. Thus we can end up with a situation where extension of labor regulations is put forward by some as the way to reduce informality, while the precise opposite, deregulation of labor markets, is proposed by others to achieve the same end.

These debates have intensified in recent years with evidence and argument that during this period of globalization driven growth, the extent of informality has not declined significantly, and perhaps even increased in some countries. This has questioned a presumed "natural" tendency for informality to decline with economic growth. Again, for some it is the economic strictures of heightened competition in an era of globalization that have led to informalization despite economic growth, or indeed as a natural concomitant of growth. But for others it is the prevalence of certain types of state intervention in labor and other markets that have prevented the growth spurt made possible by globalization from being translated into a decline in informality.

This paper hopes to clarify the precise sense in which informality is bad—a trap for development and growth—and to highlight policies that could help escape the trap. A key component of the argument is achieving clarity on what exactly is meant by informality by different participants in the analytical and policy debates, and to show how these different perspectives lead naturally to their policy prescriptions. Based on this clarification, and the anchor of a well specified objective function for development policy, we can then discuss and delineate policies for avoiding the informality trap.

The plan of the paper is as follows. Section 2 sets about clarifying the notion of informality, and looks at recent trends in informality. Section 3 takes up the issue of the precise sense in which informality is trap at the individual and economy wide level. Section 4 follows on from this to propose a policy framework for avoiding informality traps. Section 5 concludes.

2. What Exactly is Informality?

Ever since the notion of informality was introduced to the literature by Keith Hart (1973), it has played a central role in the development discourse. There are many reasons for this. The notion has been elastic enough to accommodate a range of interpretations with sufficient commonality to allow the interpreters to feel they were discussing the same phenomenon. Hart himself used informality to denote economic activity that was outside the reach of state regulation, either because regulations did not apply or because they were not enforced. But in the subsequent literature informality was also seen in light of an earlier discourse on "dualistic development" (Lewis 1954), characterizing the economy as divided into a "modern" and a "traditional" sector. Informality has been linked to poverty and to economic activity with low productivity and low income generation prospects. And, most recently, it has been expanded to capture generally all employment in which there is no employer provided social protection. Cutting across these related but different uses of the term informality are the concepts and operationalizations used by official statistics, which frame the policy debates by producing figures on the levels and trends in informality.

It is useful to start with official definitions of informality as an entry point into measurement and concepts. The Indian National Commission on Employment in the Unorganized Sector (NCEUS) captured recent trends in the debate defining informality as follows:

"*Informal Sector*: '…..all unincorporated private enterprises owned by individuals or households engaged in the sale and production of goods and services operated on a proprietary or partnership basis and with less than ten total workers'.
Informal worker/employment: '….those working in the [informal] sector or households, excluding regular workers with social security benefits provided by the employers and [including] the workers in the formal sector without any employment and social security benefits provided by the employers'.
Informal economy: The informal sector and its workers plus the informal workers in the formal sector constitute the informal economy." (NCEUS, 2009, p. 3)

The NCEUS statement crystallizes a broadening in the concept of informality in terms of official statistical sources. The traditional definition, still prevalent, is based on the characteristics of units of economic activity. Here is how the International Conference of Labor Statisticians (ICLS) puts it:

"Conceptualizing the informal sector as a subsector of the SNA institutional sector "households", the Fifteenth ICLS defined *informal sector enterprises* on the basis of the following criteria:

-They are private unincorporated enterprises… i.e. enterprises owned by individuals or households that are not constituted as separate legal entities independently of their owners, and for which no complete accounts are available that would permit a financial separation of the production activities of the enterprise from the other activities of its owner(s)….

-All or at least some of the goods or services produced are meant for sale or barter….

-Their size in terms of employment is below a certain threshold to be determined according to national circumstances, and/or they are not registered under specific forms of national legislation (such as factories' or commercial acts, tax or social security laws, professional groups' regulatory acts, or similar acts, laws or regulations established by national legislative bodies as distinct from local regulations for issuing trade licences or business permits), and/or their employees (if any) are not registered.

-They are engaged in non-agricultural activities, including secondary non-agricultural activities of enterprises in the agricultural sector." (ICLS 2003, p. 48)

This definition captures several strands in the conceptualization of informality. The Lewis (1954) modern/traditional dichotomy is present in the incorporated/unincorporated distinction ("no complete accounts available"). The Hart (1973) perspective is further present in the criterion that a range of laws and regulations do not apply to these enterprises. The size criterion, present in many if not most official definitions (including that of NCEUS above) is important because, as we shall see, smallness of size is often associated in the literature with low productivity and growth potential. Finally, note that agriculture is excluded in this definition, although some authors include agriculture as part of the informal sector.

With the above basis, Chen (2006, p 76) points to a recent drive to widen the circumstances relative to which informality is defined:

"…extend the focus to include not only *enterprises* that are not legally regulated but also *employment relationships* that are not legally regulated or protected. In brief, the new definition of the 'informal economy' focuses on the nature of employment in addition to the characteristics of enterprises."

The NCEUS (2009) definition captures this broadening, as does the recent OECD publication, *Is Informal Normal?* (Jutting and de Laiglesia, 2009):

"Informal employment refers to jobs or activities in the production and sales of legal goods and services which are not regulated or protected by the state." (Jutting and Laigelesia, 2009, p. 17).

Of course this broadening then has to be operationalized, and the NCEUS (2009) definition is one such attempt for India. The essence of the operationalization, however, is to add to employment in the traditionally defined informal sector the employment in the formal sector which is not protected by the state (the latter itself being operationalized by NCEUS as cases where there is not employer provided social security benefits). Employment in the informal sector, therefore, is smaller than employment in the informal economy. However, national statistics are not as yet fully geared to producing estimates of employment in the broader informal economy. As Charmes (2009) notes, "the use of proxies is till necessary for understanding trends in informal employment" (p.30). Self-employment is one such proxy:

"Self-employment is the complement to wage employment (employees) in total employment and comprises own-account workers, employers, contributing family workers and members of producers' cooperatives...The growth of self-employment...can be interpreted as an indicator of the growing importance of less codified labour relations and therefore of informalisation.' (Charmes, 2009, p. 30).

Other authors rely on household surveys, and questions asked of workers about their work conditions, to identify the extent and nature of informality (for example, Unni, 2005 and NCEUS 2009).

Do these alternative definitions and conceptualizations matter in terms of the broad picture on the extent of informality? The answer is that for South Asia the sheer magnitude of informality is so high, that while the alternative conceptualizations matter a lot for the discourse on what to do about informality, they are not so important for the broad numerical characterizations of informality at the national level. Thus, for example, in recent review on informality in South Asia, Chen and Doane (2008) conclude as follows:

"According to recent national labour force surveys, informal employment comprised a significant share of non-agricultural employment in all countries: accounting for 62 per cent of non-agricultural employment in Bangladesh, 72 per cent in India, 74 per cent in Nepal and Pakistan, and 45 percent in Sri Lanka....Since a relatively large share of total employment is in agriculture and employment in agriculture is largely informal, the share of informal employment in total employment is higher still accounting for 79 per cent of total employment in Bangladesh, 92 per cent in India, over 80 per cent in Nepal, and 66 per cent in Sri Lanka."

In a forthcoming World Bank (2011, Figure 2.6)) study, the following estimates are given of the share of informal employment (per cent) in non-agricultural employment and in total employment (per cent) respectively: Afghanistan (79, 92), Bangladesh (74, 87), Bhutan (51, 88), India (72, 88), Maldives (21, 40), Nepal (82, 95), Pakistan (78, 88), Sri Lanka (58, 71). Notice the broad agreement between these figures and those cited by Chen and Doane (2008). Notice also (apart from the island state of Maldives) the sheer size of the informal economy in all of these countries.

On trends, however, some differences emerge between different estimates. Charmes (2009) finds that the share of informal employment in total non-agricultural employment rose from 76.2 per cent in 1985-89 to 73.7 per cent in 1990-94, to 83.4 per cent in 1995-99. But the World Bank (2011) study reaches different conclusions for India for a later data set, and it has trends for other South Asian countries:

"A mixed picture emerges in the six countries where more than one data point exists. In two, Bangladesh (2002 and 2008) and Pakistan (2000 and 2008), there has been no change. In two others, India (2000 and 2005) and Sri Lanka (2000 and 2008), informal employment declined significantly as a share of total employment while in Bhutan (2003 and 2007) and Nepal (1998 and 2008), it increased significantly. However, it should be noted that the concepts used to measure informality in all four of these countries did change from the early to late year so it is not clear how much of the observed change was real or a result of how informality was measured. Interestingly, in Bangladesh and Pakistan where no change was observed, how informality is measured did not change in the surveys." (World Bank 2011, Chapter 2, p 19)

Even in countries where informality is on the decline, there remains the question (in India, for example) of whether the decline is fast enough relative to the rapid rate of growth of the economy as a whole.

The informal sector and the informal economy remain overwhelmingly large in South Asia. It should not be surprising, therefore, that it is also heterogeneous. To begin with there is the issue of agriculture versus non-agriculture. Assessments of the evolution of informality at the national level cannot be divorced from a general discussion of the transition of an economy from an agricultural base towards manufacturing and services. Even within non-agriculture there is a spread between self-employed entrepreneurs, own-account workers, unpaid family workers, causal labour, etc (Chen 2006). And there is heterogeneity across sectors:

"In India,…33 per cent of all male informal workers are engaged in trade, 23 per cent in manufacturing, 16 per cent in construction, 21 per cent in other services (mainly in transport and storage), and 7 per cent in other sectors….In Pakistan, the sector in which the largest percentage of all informal workers is engaged is ….trade (34%) followed by manufacturing and personal services (both around 20%)." (Chen and Doane, 2008, p. 9)

This heterogeneity should warn us against a uniform policy towards the informal sector, and this will be taken up in later sections.

Another type of heterogeneity is emphasized by Kanbur (2009) as particularly relevant for how policy debates are framed. He follows through on, and specifies in greater detail, conceptualizations where formality and informality are seen as pertaining to state regulations and laws. Those economic activities which come under the purview of a given set of rules and laws, and do not evade them, are conceptualized as “formal” (A). But it should be noted that there are then two distinct categories of “informal”: activities that are covered but are evading these regulations illegally (B), and activities that are not covered at all by the set of state rules and laws being discussed. And even within the second of these there are two further categories—those that have adjusted their activity to avoid the regulation by falling outside its purview (C) and those that would always have been outside the purview of the regulations (D). These four categories of economic activity—A, B, C and D—turn out to be central in framing opposing policy positions. Thus those who see labor and other regulations as being the “cause” of informality focus on category C. Those who support direct interventions to help the informal economy focus on category D. Very few discuss category C explicitly, although evasion of laws is sometimes part of the discourse of those who support and oppose labor regulations. Of course getting empirical estimates of these different types of informality is not easy, it is almost non-existent in the literature, even though they turn about to be crucial in policy positions taken up by different groups in the informality discourse.

3. Why is Informality Bad?

There are different senses in which informality can be seen as being “bad”. The most obvious is that it is correlated with low incomes and with poverty status. For India, the NCEUS (2007, p. 24) estimated that:

> “Workers in the unorganized sector had a much higher incidence of poverty (20.5 per cent) than their counterparts in the organised sector (11.3 per cent), almost double. This is an indicator of inadequate income levels and the extent of vulnerability of workers in the unorganised sector…”

Surveying global estimates, a recent OECD study concludes as follows:

> “Informal jobs are often precarious, have low productivity and are of low general quality…Moreover, certain groups, such as the young or women, seem to be over represented within this category of jobs.” (Jutting and de Laglesia, 2009, p. 18).

The central issue for policy, however, is that of causality. Is informality a mere correlate of poverty and low development, an indicator that captures broader processes, or is the informality itself the cause of poverty and a break on development? The literature touches on both aspects of informality.

Linking to the early literature on growth and development, for example in the Lewis (1954) model of development, a decline in the relative weight of the traditional sector was seen as a natural concomitant, and an indicator of growth a development. In the Lewis (1954) model a traditional sector supplies labor to the modern sector at a wage given by subsistence. As the modern sector expands through capital accumulation, labor transfers to this modern sector and the transfer is necessary for, and a correlate of, economic growth. Lewis (1954) saw the agricultural sector and the urban petty trade and casual labor sector as being the supplier of labor to the modern capitalist sector (which in his formulation included manufacturing and plantation agriculture). Now, in the this set up of “unlimited supplies of labor” there would be no improvement in the standard of living of workers as economic growth took place, but the size of the informal economy would diminish over time until the "Lewis turning point" was reached and wages started rising in the traditional sector as well. In this perspective, therefore, informality is bad because it is a signal of an insufficiently low level and pace of development, and a signal of the time still needed before incomes in that sector start rising. But notice also that in this perspective, "informality"—a traditional sector which supplies labor to the modern sector at a given wage—contributes to accumulation and hence growth by keeping wages down.

In contrast to the Arthur Lewis's "classical" model of the economy, once the Lewis turning point is reached we are in a post-Lewis "neo-classical world" in which two sectors (manufacturing and agriculture, say) compete for labor. But if in one of these sectors (manufacturing) the labor market is not perfectly competitive, so that wages are kept above their marginal product through labor power or state intervention. This induces migration in the hope of a "good" job, but not all migrants can get these jobs, and this creates a pool of labor which is neither in agriculture nor in manufacturing, but waiting for a chance of getting into the good jobs sector. This labor engages in a number of activities that are low productivity and low income, this low income being balanced by the prospect of a high income job. Lewis (1954) already had in mind this sort of activity when he talked about

"…the workers on the docks, the young men who rush forward asking to carry your bag as you appear, the jobbing gardener, and the like. These occupations usually have a multiple of the number they need, each of them earning very small sums from occasional employment…..; retail trading is also exactly of this type; it is enormously expanded in overpopulated economies; each trader makes only a few sales; markets are crowded with stalls….." (Lewis, 1954, p 2).

This type of employment matches well the informal sector and informal work discussed in the previous section. However, in the line of argument developed by Harris and Todaro (1970), and others, the "cause" of this informality is very clearly the above market clearing wage in the (what we might now call) the formal sector. If the high "minimum wage" or labor regulation more generally, did not exist, then the informal sector would not exist either. Here the informality is bad not only because those in informal activity have a low income, but because labor allocation is inefficient.

Generalizing beyond labor regulation to regulation of enterprises, the argument goes that as a result, the (non-agricultural) informal sector also has enterprises that are avoiding or evading the regulations that define formal activity. That these enterprises are smaller than those in the formal sector follows from the structure of regulation and its evasion—regulations might apply only to enterprises above a certain size, or enforcement of regulations might be particularly difficult for small enterprises. Either way, it is then argued that enterprise size in the informal sector is sub-optimally small, foregoing economies of scale and dynamic prospects of investment and growth. This argument has been made powerfully for Latin America by Santiago Levy (2008). For South Asia, the thrust of the "missing middle" discourse is essentially that enterprise regulation has led to a bimodal distribution of enterprise size, with enterprises having to be either very large to overcome the costs of regulation, or very small to avoid them. For India this argument has been made forcefully by Mazumdar and Sarkar (2008), and it is extended South Asia wide by World Bank (2011, Chapter 4, Figure 17):

"…the average large firm is over 25 percent more productive than the average micro firm in South Asia, with a natural progression of increasing productivity from smaller to larger firms. A main rationale for the policy interest in avoiding a "missing middle" is that it is symptomatic of constraints impeding productive smaller firms from growing into more productive large firms, and larger more stable employers." (World Bank 2011, Chapter 4, p. 24)

This low productivity of small enterprises translates into low wages for their workers and low incomes for their owners, linking the productivity and growth perspective to a perspective driven by poverty.

The above argument would seem to be cut and dried—the regulations that define the formal sector also, in effect, create the informal sector of small scale enterprises with low productivity and low incomes. The informal sector is "bad" in this sense, but escaping the trap depends on the regulations being lifted. However, not all small scale enterprises are small because they are avoiding or evading regulations. In terms of the categories A,B,C and D introduced in the previous section, there is still the category D—these are activities that are not touched at all by regulation and would remain small with low productivity and low incomes even if the regulations that bind the formal sector were removed.

To give an illustrative example, suppose the regulation stated that an enterprise has to register and then pay various worker benefits if its size exceeds 9 workers. Now consider an enterprise that would have been 15 workers without the regulation. This enterprise has three options. It could continue to have an enterprise size greater than 9 and comply with all relevant regulations (but presumably be of size less than 15 because of the costs of the regulations), in which case it would be formal (A). It could continue to have an enterprise size greater than 9 but evade the regulations (but presumably at an enterprise size much less than 15 because smaller size aids evasion). This would be informal category B. Or it could adjust its size just below 9 so that the regulations do not apply to it (category C). But what of enterprises whose "natural size" i.e. the size even without regulation, is below 9 (category D)? Enterprises in category D would be classified as informal, they would be small, and for that reason have lower productivity and low incomes, but removal of regulation would not be the way of releasing the informal trap.

Before proceeding further one caveat should be noted. While informality is certainly strongly correlated with low incomes and poverty, it is not all bad news. There is heterogeneity within the informal economy, and above poverty incomes can also be found in this sector. For India, NCEUS (2007, p.50) documents this for India and comments further as follows:

"The Commission considers it important to also emphasize the fact that the category of self employed, unlike that of casual workers, is not necessarily and uniformly poor. As we shall see later in this Chapter, there are those with some significant physical and/or human capital and also those with very little capital. Independent professionals such as doctors, architects, lawyers, accountants, small workshop owners, urban shop owners, etc. may be self employed but with incomes that are several times higher than a street vendor, rickshaw puller or a handloom weaver. Our focus and concern here is on the latter groups, who lack the critical minimum by way of either physical or human capital or both."

This perspective is also confirmed at the global level by the ILO (2002, p.31)) recognizes:

"….the links between working informally and being poor are not always simple. On the one hand, not all jobs in the informal economy yield paltry incomes. The background studies prepared for this report indicate that many in the informal economy, especially the self employed, in fact earn more than unskilled or low-skilled workers in the formal economy. There is much innovation and many dynamic growth-oriented segments in the informal economy, some of which require considerable knowledge and skills. One of these is the fast-growing information and communications technology (ICT) sector in the large cities of India."

At the very least this heterogeneity cautions against a uniform policy stance. It also suggests that it may not be informality in and of itself that is the sole cause of poverty; it has to be seen in conjunction with other factors and policy has to address these other factors as well.

Finally a related issue at the micro level is whether there is in fact mobility out of informality and poverty, or whether there is persistence over the working life of an individual, and perhaps across generations. Fields (1975, 2005) introduced the idea of the informal sector as one where workers can be seen as waiting to move from "bad jobs" to "good jobs", and that within the informal sector there could be a lower tier and upper tier of bad and less bad jobs. In Latin America there is now growing evidence of significant mobility between formal and informal sectors. In Mexico, for example, 19.7 percent of workers in the informal sector in 2002 were in the formal sector in 2005, while 18.2 per cent of workers in the formal sector ended up in the informal sector three years later (Gagnon, 2009, Box 5.2).

We do not, unfortunately, have the same extent of information on mobility by labor market status for South Asia, mainly because of the paucity of panel data sets. For mobility by poverty status, based on household survey panels, Mckay and Baulch (2004, Table 1)) present estimates for the probability that a household with consumption below the national poverty line would still be poor in five years' time. The range of estimates is 25%-35% for India, Pakistan and Bangladesh. This means, of course, that the probability of moving out of poverty is in the range 65% to 75%. Bhide and Mehta (2010) review the results on rural poverty dynamics in India and conclude as follows:

"The fact that a fairly significant proportion of the poor continue to remain poor over long periods of time, significant proportion exit from poverty, and many non-poor enter into poverty highlight the need to understand the factors that influence this dynamics…. In summary, factors that are related to the *persistence of poverty* are the scheduled tribe status, larger household size, increase in household size, larger number of dependent children and increase in number of dependent children.
Escape from poverty is enabled by literacy, ownership of a house, increase in cultivated area and income from livestock. In addition, infrastructure and a large urban population in the neighbourhood were other factors that helped exit from poverty."

To the extent that poverty and informality are correlated, the above suggests both that there is mobility, and that the escape from poverty is dependent on a range of factors going beyond informality itself.

To summarize, there are several perspectives in the literature on the question of why informality is bad—macro versus micro, and correlation versus causation. At the macro level, in a dual economy framework the size of the informal sector is seen as an indicator of the level of per capita income and development since growth in the modern sector relies upon and then depletes labor in the traditional sector. At the same time, at the micro level dynamism and growth potential is seen to be negatively affected by the smallness of size of enterprises in the informal sector. There is also the issue of the extent to which regulations and laws affecting the labor market protect those in the informal sector, and the extent to which they instead stand in the way of transmitting the beneficial effects of economic growth to the poor in the informal sector, and escape from the informal sector to the "better jobs" in the formal sector. With this background, we now move to a discussion of policy options for avoiding "informality traps."

4. How Can Informality Traps Be Avoided?

Informality—defined as a larger share of the economy accounted for by activity outside the net of a well defined set of state laws and regulations (categories B, C and D of the Section 2)—is very high in South Asia compared to the global average. Moreover, it has not declined by nearly as much as might be predicted by growth rates in the region. Particularly in the last two decades, growth rates have been at historical highs, and yet the size of the informal sector has not decline by very much. Indeed, by some accounts it may actually have increased.

Before discussing policy responses to these trends, let us consider possible explanations for them in terms of the framework developed in Section 2. A useful way of approaching this question is to ask how each of the three categories of informal activity—B, C and D—might have behaved over the past two decades.

Category B is economic activity that is covered by regulation but the regulation is being evaded, illegality in other words. The size of this category is determined by the strength of enforcement. It has been argued that in the face of growing global competition, authorities are increasingly "turning a blind eye" to evasion of regulations such as on registration and worker benefits if the enterprise is larger than 10 workers. Although difficult to isolate directly in official statistics for obvious reasons, indirect evidence on minimum wage violation, and anecdotal backup, suggest that this feature has indeed increased over the last two decades:

"The labour inspection services in many developing and transition countries are not adequately staffed or equipped to effectively enforce standards in the informal economy, especially in terms of covering the myriads of micro- and small enterprises or the growing numbers of homeworkers… The system of labour courts and industrial tribunals, especially in developing countries, may be very weak, may lack resources and is all too frequently corrupt. Strengthening the labour administration and justice systems and promoting good governance would go a long way to achieving decent work and enabling informal workers to move into the formal economy." (ILO. 2002, pp 52-53).

Category C is economic activity that has adjusted itself to be outside the purview of the regulation and thus to avoid the regulation in this way. As noted earlier, an example would be an enterprise that would have hired 15 workers but chooses now to hire 9 workers to avoid registration and the obligations and costs that would then follow. Another example would be an enterprise that would have been vertically integrated, with many functions from cleaning to accounts carried out by enterprise employees. These functions are now outsourced, to enterprises which are less than 10 workers.

Category C is the one around which most of the debate on regulations has focused. The fact that firms adjust their operations to avoid regulation has been seen as evidence of the inappropriateness of the regulation. To many, the large size of the "informal sector" is nothing other than a testament to the private and social costs of the web of regulations that they are trying to avoid by (legally) getting out of the way. To others, the increase in informalization through this category is a reflection of the evolution of technology. Breaking up of production processes into smaller components is now possible in a way that it was not three decades ago—the rise of "cluster based" production in China is but one example of this (Long and Zhang, 2009). In this view the increased informalization is explained by changing technology in the face of current regulation structure appropriate for the costs and benefit structures of activity integration of three decades ago. More generally, the point being made is that part of the explanation of category B informality is the evolution of the regulation structure itself relative to the evolution of technology.

Note also that categories B and C are not entirely independent of each other. A more lax enforcement structure will increase the share of category C, but for that reason will decrease the share of category B—there is now less reason to adjust economic activity to get out of the way of regulation, since the regulation itself is being enforced less intensively.

Finally, let us come to category D—those activities that are outside the scope of current regulation. If this category has grown in relative size then it could be either because of the retreat of some types of regulation, or because of increasing difficulties of activities to evolve in a way that brings them into the regulatory net—specifically, difficulties of activities growing to a size sufficient to warrant their registration (taking into account the costs and benefits of regulation).

With this background, and building on the discussion in the last two sections, there are two lines of argument which point us to the reasons for and the interventions needed to avoid informality traps. The first focuses on the efficiency and growth costs of high levels of informality, while the second highlights the distributional consequences. Both would like greater formality, but may differ on the methods for achieving this.

Taking the efficiency angle first, it is possible to further classify the arguments into two broad themes. The first pays great attention to size of enterprise. It argues that enterprise size in the informal sector in developing countries is too small to reap the gains from efficiency, and the costs imposed by regulation on the formal sector encourage the adoption of smaller enterprise size than would otherwise be the case, by those that come under the purview of the regulation. This can happen in one of two ways. When registration is required at a certain enterprise size, the enterprise can decide not to grow beyond that level even though it has the potential to do so. Or it can grow beyond that size but evade the regulation—the argument now is that the size will still be lower than the firm would otherwise wish it to be, because evasion is easier for smaller enterprises. To this are added other costs of illegality, all of which hamper growth and efficiency.

The second theme in the efficiency strand of concern over rising informality is that by remaining informal, an economic activity loses access to contractual and other benefits that accrue through state legal and service structures. There are several elements to these arguments. For example, registration of an enterprise can bring benefits through recognition in courts. Thus although the firm may face some costs of registration, such as having to pay employment benefits, it gets benefits as well. This is of course in principle—it all depends on how well the courts and contracts enforcement work. But this line of argument takes us to category D, those who are completely outside the net of regulations and laws. If a subset of these laws, for example those pertaining to property rights, could be extended to this category then, it is argued by Hernando de Soto (2000) and others, the productive potential of even quite small home based enterprises in the urban slums could be enhanced by allowing them to use their property as collateral.

Notice, however, that while the first theme above seems to suggest a narrowing of the purview of the state, for example registration and worker benefits being required at a much larger size of enterprise to encourage increase of enterprise size, the second suggests (albeit in a different domain) a broadening of the purview of the state, for example providing legal protection of the courts in the heart of urban slums.

Let us turn now to more distribution based concerns about the trend of growing informality. First of all notice that there is some convergence between the efficiency and distribution based views for category D of informality—those activities that are completely outside the purview of the state. For some state interventions, for example integration into the legal system, if it could be done well, there might be agreement that this could be efficiency enhancing and distribution improving, since this category will generally contain among the poorest of society.

But consider now the distributional concern on increasing informality that flows from the fact that, by and large, workers in the informal sector do not have social security benefits. This is either because enterprises are not legally required to provide these benefits (categories C and D), or because they are required to but are not providing them (category B). If the response to this is to extend the scope of state regulation by, for example, decreasing the size of enterprise at which registration and the payment of benefits becomes mandatory, then this could lead to a further decline in enterprise size and thus loss in productivity feared by the efficiency strand of the concern over growing informality. However, if the response is to provide social security benefits through more general means, not tied to place of work or enterprise, then the efficiency concern may be mitigated (Levy, 2007).

Based on the above discussion, it should be clear that there is no single overarching policy intervention that could address the growth and poverty consequences of the high and stubbornly stable levels of informality in South Asia. If the objectives of policy combine efficiency and distribution, then a number of interventions could enhance both:

(i) Improved enforcement of regulations (to reduce the size of category B).
(ii) A review of regulations, particularly the enterprise size cutoff, in light of new technology and competition which changes the old cost benefit of optimal enterprise size (to reduce the size of category C).

(iii) An expansion of state services, both hard and soft infrastructure (the latter including property rights and contract enforcement), to enhance the productivity of those outside state structures (to reduce poverty in category D and to aid their mobility into formality).

Let us discuss each of these in turn, and the possible tradeoffs that policy makers may face.

To many, the widespread violation of labor and enterprise regulation that is seen in South Asia and elsewhere in developing countries is itself an indication of the inappropriateness of the regulations. Whatever the resolution of the debates on the regulations themselves, there is little point in passing laws and regulations without at the same time focusing on their enforcement, including in this the inspections and monitoring, as well as court proceedings. There is a strong case for strengthening labor inspectorates as well as enterprise inspectorates more generally to ensure that laws and regulations are complied with.

The sharpest debates in the literature concern the role that regulations themselves play in creating informality, by inducing adoption of production structures that avoid them. Such avoidance will always be present—the real questions are to do with how easy it is, how socially costly it is, and how regulations need to be adjusted to the costs and benefits of avoidance (and evasion). The "missing middle" literature on South Asia suggests strongly that regulations conditioned on enterprise size of say 10 workers lead to enterprises that are below this size to avoid the regulation or well above this size to recoup the costs of regulation. This would lead to a recommendation to raise the enterprise size at which regulations bite, which would help to induce more enterprises to become formal. At the same time, changes in technology and the pressures of competition may be leading to greater viability of smaller scale enterprises, which would suggest a tightening of the enterprise size at which regulations bite. There is no clear answer to this question, which needs more empirical research to establish the tradeoffs.

The distinction between category C ("informality by choice") and category D ("naturally informal") is a key one in the policy debates in South Asia and globally (see for example Maloney, 2004, and Chen, 2006). If category C was dominant, then the focus would be on regulations governing enterprises and their enforcement. If on the other hand category D was dominant, then the focus would be on how to help those who are outside the current swathe of state regulations. Unfortunately, there is no detailed empirical work that gives us a handle on the relative size of "informality by choice" and "naturally informal" in South Asia. However, given the huge size of the informal economy, it is likely that category D is of substantial significance.

Direct assistance to the "naturally informal" sector must therefore play an important part of any policy framework to address informality as a cause of low productivity and poverty. Chen and Doane (2008, pp 35-36)) propose an array of policies under the headings of Regulation, Protection and Promotion. Specific policies include: "regulation (and taxation) of informal enterprises", "legal protection of informal workers and enterprises, including commercial rights for informal businesses, labour rights for informal wage workers, property rights for all informal workers"; social protection all informal workers through targeted schemes, universal schemes, some mix thereof"; "raising productivity of informal enterprises "; and "increasing employability of informal workers."

The above emphasizes again that no single solution will do—a range of interventions is needed. It is this broad perspective that leads the OECD to propose a three-pronged strategy for addressing informality:

"…Informal employment comprises different phenomena that require distinct policy approaches…..:

1) For the world's working poor, working informally is often the only way to participate in the labour market. Policies should consequently try to unlock these people from their low-productivity activities….Specific recommendations include active labour market policies such as training and skill development programmes, that reopen the doors to formality.
2) If informal employment is a deliberate choice to avoid taxes or administrative burdens…[c]ountries should aim to introduce formal structures that can offer the same or (higher) levels of flexibility and efficiency that informal channels occasionally may provide….[This report also] advises countries to spend more resources on labour inspections…..
3) In many countries, finally, informal employment is mainly a consequence of insufficient job creation in the formal economy. [This report] thus also recognises the need for a general push for more employment opportunities within the formal sector."

5. Conclusion

The central thrust of this paper is to emphasize the heterogeneity of the informality discourse. While informality has a core commonality of concern in analysis and policy, there are diverse conceptualizations, diverse empirical measurements, diverse causal channels and theories of informality, and diverse policy concerns. For policy, the single most important conclusion is that there is no "silver bullet" to address the concerns that arise with informality, and that a range of interventions need to be examined and implemented.

The conceptualization of informality ranges from the "traditional" sector of Lewis (1954), seen in contradistinction to a "modern" or "capitalist" sector, through "activities outside the reach of the state regulation" of Hart (1973), to "lack of employer provided protection and benefits" of ICLS (2003). In between, and overlapping, are conceptualizations and empirical implementations that touch on organization structure of enterprise, size of enterprise, and poverty and vulnerability of workers (for a full review, see Guha-Khasnobis, Kanbur and Ostrom, 2006).

Alternative conceptualizations and measures do not make a big difference to the size of the informal sector, which is very large in South Asia, or to the conclusion that it has not declined commensurate with the growth rates of countries in the region. Where the differing perspectives do make a difference however, is in policy prescriptions—with some measures receiving greater emphasis than others depending on the core conceptualization in play.

The literature as a whole, however, suggests that a range of policy interventions will be necessary to address the issue of informality. Higher growth, but growth whose sectoral pattern is more labor absorbing is the first and most general policy conclusion. With given level and structure of growth, extending the coverage of state protection to workers currently uncovered is the second recommendation. At the same time, reviewing current interventions to improve their flexibility and application is also needed. Direct measures to increase the productivity and incomes of enterprises in the informal sector, which includes targeted measures of training and enterprise support as well as general measures of bringing legal and other state infrastructure support to these enterprises, are another recommendation. Finally, better enforcement of regulations that do exist, and assessing enforcement possibilities before regulations are passed, are also recommendations that emerge from the literature.

Informality has not disappeared in South Asia, and is unlikely to do so in the coming two decades. Policy makers need to recognize that it is a complex phenomenon and that it is an integral part of economy and society. Addressing informality to reduce poverty and spur development requires a better understanding of the phenomenon, the readiness to eschew simplistic single solutions, and the willingness to adopt a wide range of country specific tailor made policies and interventions.

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