

# Informality, Inclusiveness, and Economic Growth: An Overview of Key Issues

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# Contents

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Foreword .....	3
1. Introduction .....	4
2. Defining informality.....	5
3. Key debates and theories.....	11
5. Informality and inclusive growth .....	16
6. Research and Knowledge Gaps: The Nexus Between Informality and Inclusive Growth ...	18
References .....	24

# Foreword

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This paper was commissioned by IDRC's Supporting Inclusive Growth program with the aim to: (i) critically examine the concept of informality and its various approaches, complementarities and tensions; (ii) identify unresolved issues and knowledge gaps; and (iii) explore an analytical framework for organizing future research in this area.

Whether referring to types or quality of employment, or to livelihood opportunities for millions of people living in low and middle income countries, informality is a defining feature. By some estimates more than 30 percent of the developing world's GDP and 70 percent of its workers are outside the formal economy. The recent financial and economic crisis is believed to have further increased its share globally.

When the concept of informality was first introduced in the early 1970s, it was considered to be a temporary phenomenon, believed to disappear as economies develop. The reality is quite different. Despite economic growth, informal enterprises and informal employment continue to be integral characteristics of developing economies in terms of their share of total employment and job creation. This raises a number of critical questions: is this a cause for worry? What are the implications for growth and for inclusiveness? How can employment and social policies deal with this?

Informality features prominently in development discourse, accompanied with a vast and growing literature. In tandem with this, there are growing inconsistencies in the way it is conceptualized and measured. It means different things to different people, which not only compounds the challenge of addressing the above noted critical questions, but it can also have important implications for shaping policy responses.

This paper is an important contribution that will enhance greater conceptual clarity in understanding the notion of informality, and the complex linkages between informality, growth, and inclusiveness. It also provides valuable input to inform future research directions.



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## 1. Introduction

Widespread informality - with regard to employment, enterprises, and productive activities - is frequently perceived as a barrier to full participation in the economy and as a hindrance to long-run economic development and poverty reduction. In part, this is because the link between, informality, growth and inclusiveness is not fully understood. 'Inclusive growth' has been defined as growth that takes place in a context in which economic opportunities (including employment opportunities) expand, the poor's access to these opportunities improves, and inequalities are reduced.<sup>1</sup> Although informality has potentially important consequences for the realization of inclusive growth, concepts of what constitutes 'the informal' are plagued with inconsistencies, wide ranging definitions, and very different assessments of the effects of informality. Most everyone recognizes that informality represents an important characteristic of developing economies, yet there is far less consensus on the appropriate policies to adopt to make growth more inclusive when economies are characterized by widespread informality.

This paper explores the concept of informality and various approaches to analyzing informality, proposes ways of linking informality to inclusive growth, and identifies knowledge gaps and research needs. In the process, significant debates, tensions and unresolved issues are discussed. The ultimate aim of the paper is to flag priority areas of research on informality which can help inform an inclusive growth agenda. Based on the review of the concept of informality, four research areas are proposed: the relationship between economic growth, economic development, and informality; barriers to mobility; understanding formal/informal linkages; and public goods and informality.

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<sup>1</sup> This definition of inclusive growth is adapted from the IDRC's Program Prospectus (2011-2016) for the *Supporting Inclusive Growth* program (Ottawa: International Development Research Centre, October 27, 2010).

## 2. Defining informality

There is no single approach to defining informality and the definitions used in theoretical and empirical research often lack consistency from one study to the next (Guha-Khasnobis, Kanbur, and Ostrom, 2006). The notion that the informal side of the economy escapes clear definition is reflected in the language used to describe it: 'murky', 'shadow', 'hidden', and 'underground' (Fields, 1975; Schneider and Enste, 2000; Gërxhani, 2004). In concrete applications, the definitions of informal employment, the informal sector, and the informal activities differ depending on whether the focus is the enterprise, the employment arrangement, or the economic activity in question. The choice of how to characterize informality is not trivial. The selection of a particular entry point shapes the analysis of the prevalence of informality, its consequences, and the appropriate policy responses.

Many approaches to informality focus on the enterprise and identify criteria to distinguish formal enterprises from informal ones. One approach emphasizes the relationship between the enterprise and the government, formal regulations, and the law. Other approaches stress the scale of operations and the relationship to the household. The 'informal sector' is often defined in terms of the enterprises which make up the 'sector' - i.e. the informal sector is comprised of all informal enterprises operating in the economy. In this regard, the informal sector is distinct from other sectoral divisions, in which 'sector' typically refers to a branch of economic activity rather than an enterprise characteristic (Kucera and Roncolato, 2008). A range of indicators are used define informal enterprises - some common ones include:

- Size. Aims to capture the scale of operations. The size criterion is frequently concretized in terms of the number of paid employees.
- Registration status or recognition by a government agency. This is meant to indicate whether the enterprise would be subject to government regulation.
- Employer/enterprise social security contributions. Along the same lines as registration status, this is meant to capture a formal relationship between the enterprise and government, linked to social protection.
- Legal form of organization and character of financial accounts. Informal enterprises are often considered to be unincorporated enterprises whose finances cannot be separated from those of the household.
- Legal entitlements and property rights. De Soto (1989) stressed the lack of legal rights, with an emphasis on property rights, as the primary characteristic of informal enterprises.

There are limits to an enterprise-based approach. For example, unregulated forms of employment exist outside of informal enterprises - in formal enterprises and in non-enterprise settings (e.g. private households). The use of size alone may be misleading when small-scale professional and highly skilled service providers are counted as informal (e.g. a doctor's office). In some cases, policy prescriptions are embedded in the definitions used. The policy response to informality

defined as a lack of individual property rights would be an extension of these rights, but this solution may exclude alternatives, such as cooperative forms of ownership and production.

To get around some of these drawbacks, employment-based definitions have been developed. One advantage of an employment-based approach to defining informality is that it has the potential to unite enterprise-based concepts with jobs-based concepts (ILO, 2002). The 17th International Conference of Labour Statisticians (ICLS) outlined its recommendations for an employment-based

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approach to defining informal employment in 2003 which combined the concept of informal enterprises with a concept of informal jobs (Hussmanns, 2004; Chen et al, 2005). Under the ICLS definition, the self-employed (employers and own-account workers) are considered to be in informal employment if the enterprise in which they work is informal - in other words, the enterprise-based approach is applied to the self-employed. In contrast, paid employees are considered to be informal if their jobs lack social protections. Under this framework, there can be formal employees in informal enterprises and informal employees in formal enterprises.

The employment-based approaches bring informal enterprises and informal jobs under a single umbrella. For many countries, this innovation is appealing. Individuals are frequently engaged in multiple activities which could include a combination of self-employment and wage employment. Moreover, people move between types of employment for various reasons - e.g. seasonal fluctuations in the availability of wage employment. Therefore, an adequate understanding of labour market dynamics in low-income countries requires a consideration of the interconnections between wage employment and self-employment.

A definition of informality which accommodates both an enterprise and a jobs based definition is useful, but there are also downsides. The employment-based definition is sufficiently broad to encompass a wide range of heterogeneous activities and very different positions within labour markets. The designator 'informal' may no longer be central for determining differences in the quality of employment relative to other characteristics of the activities in which individuals are engaged. There is a risk that grouping employment types under a broad concept of informality masks variations along other dimensions which affect job quality, earnings, economic risk, and well-being.

A third set of definitions of informality, and related concepts, are those which focus on illegal or 'underground' activities or practices (Gërxhani, 2004). The specific type of illegality varies depending on the application in question: tax evasion, violation of labour standards and laws, or trade and production of illicit goods and services.<sup>2</sup> In these cases, individuals and enterprises

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<sup>2</sup> There are a large number of terms which attempt to capture these distinctions and not all of these approaches use 'informal' as the overarching category. Feige (1990) proposes four categories under the heading 'underground

operate outside of the law because it is beneficial for them to do so relative to the perceived costs. Related to definitions which frame informality in terms of illegality, other approaches define the 'shadow economy' as those activities which are not measured or recognized by official economic and labour market statistics (e.g. Schneider and Enste, 2000). Examples include production and distribution of illicit goods and services, 'under the table' exchanges, and employment of unauthorized migrants (or other 'unrecognized' groups). Since, by definition, the shadow economy is not reflected in official statistics, indirect measurements are used to gauge the relative size of these activities and trends over time.<sup>3</sup>

Which of these definitions of informality is the correct one? The answer to this question depends on what the research or policy objectives are. To give just one example, relying on an indicator of the extent of illegal activities would not be appropriate for analyzing unprotected or vulnerable employment - i.e. many individuals engaged in legal activities lack social protections. Table 1 summarizes a range of definitions, their possible research applications, and their limitations. For the remainder of this paper, the term 'informal' - when applied to employment, productive activities, or enterprises - will be used to refer to a lack of formal social protections or regulatory

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oversight, unless otherwise specified.<sup>4</sup> We select this definition since it can be used to describe a distinct aspect of employment arrangements that has implications for inclusive growth and this specific aspect is not better captured by an alternative concept (e.g. such as the scale of operation).

The classification of enterprises, employment, and activities as informal or formal may not be the most important distinction needed for identifying the barriers to more inclusive growth. The concept of informality is often closely linked to other characteristics of enterprises or jobs, and informality may at times be used as an imperfect proxy for capturing these alternative characteristics. Therefore, it is helpful to step back and briefly examine these distinct, but closely related issues. To illustrate the importance of this point, we examine three areas that are related to, but not synonymous with, informality: enterprise size, status in employment, and tax evasion.

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economy': the illegal economy, the unreported economy, the unrecorded economy, and the informal economy. Some studies which focus on violations of labour laws do not use the term 'informal' when referring to unregulated employment (Bernardt, McGarth, and DeFilippis, 2007).

<sup>3</sup> Examples of indirect approaches include using indicators of economic activity other than the national accounts to impute the size of the informal or shadow economy (e.g. demand for currency for transactions purposes or demand for electricity). The MIMIC (multiple indicators multiple causes) methodology identifies supposed causes of informality (e.g. labour market regulation or tax to GDP ratios) and indicators of informality (e.g. unexplained electricity consumption). Econometric techniques are then used to estimate the unobserved 'shadow economy' or 'informal economy'. This technique does not test causes or indicators directly, since the variable measured (the informal economy) is not observed.

<sup>4</sup> This approach to informality is similar to that of Guha-Khasnobis, Kanbur, and Ostrom (2006) whose preferred option is to define the informal-formal continuum in terms of the 'nature and extent of government intervention in economic activity' (p.7).

Size and economies of scale. As discussed above, enterprise size has been used to define informal firms and the informal sector. Moreover, it is common to find strategies for private sector development focusing on micro, small, and medium enterprises (MSMEs). Enterprise size is closely related to economies of scale, with economies of scale playing a central role in many theories of economic development. Specifically, a movement of productive resources into sectors characterized by economies of scale (e.g. out of agriculture and into industrial activities) has been seen as a primary source of productivity improvements, higher average earnings and better living standards, and the development of domestic markets (Kaldor, 1967). An inability of informal firms to upgrade in order to take advantage of economies of scale is associated lower average productivity. A concentration of economic activity in low-productivity, informal activities reinforces slower growth and poorer economic performance (Levy, 2008).

Table 1. Definitions of informality and research applications.

Definition	Research application and limitations
Registration status of enterprises (enterprise-based)	Attempts to capture enterprises that operate without government recognition or regulation (both de facto and de jure). Used to assess lack of access to government services and absence of regulation. Limitations: registration with a government authority may not represent a meaningful distinction with regard to actual practices.
Existence of social protections linked to employment (employment-based)	Attempts to capture precarious, vulnerable, and unprotected forms of employment. Limitations: often applies only to paid employees. Different criteria needed for self-employment. The nature of social protection varies across countries.
Size of enterprises (enterprise-based)	Often used as a proxy for informal enterprises. Potentially useful for analyzing the economics of small-scale firms. Limitations: size is an imperfect proxy for other aspects of informality. Size often defined only in terms of number of paid employees.
Illegal labor practices (employment-based)	Attempts to specifically measure the extent to which labour laws are violated by employers. Limitations: illegality is underreported in statistical sources. Legal forms of employment may be precarious and lack protections. Labour laws are different across countries.
Tax evasion and avoidance (enterprise-based)	Used in studies of the costs and benefits of informality. May be used as a proxy for other types of regulatory avoidance/evasion. Potentially useful for measuring fiscal leakages due to informality. Limitations: tax evasion/avoidance may also be widespread among firms that would otherwise be considered formal. May not capture labour market vulnerability/lack of social protection. Use as a proxy for other regulatory evasion may not be well-founded. Often fails to take into account taxes which informal firms do pay.
Non-contribution by employers to social security	Similar to tax evasion/avoidance, but with a more explicit connection to social protections. Limitations: different countries

programs (enterprise-based)	have very different social security systems. May not adequately capture labour market vulnerability/lack of social protection. May not be relevant for firms without paid employees.
Enterprise finances are not separable from those of the household (enterprise-based)	Captures many factors commonly associated with informal enterprises (small-scale, lack of formal organization, close link to household livelihoods). Limitations: data is rarely available to operationalize this definition.
Trade/production of illicit goods and services	Primary aim is to study illegal aspects of the economy. Limitations: data on these activities is extremely limited. May not be closely related to other approaches to defining informality.
Unmeasured and unrecorded economic activities.	Primary aim is to document economic activities which are not measured or counted in official statistics - informal is equated to hidden or underground. Limitations: since these activities are not documented, indirect measurements involving significant methodological assumptions are required.

However, framing research questions in terms of 'informality' may not be helpful if the central policy concern is about enterprise size, scale of operations, and upgrading. This is not to say that informality and size may not be related. Some have suggested that the costs of operating informally increase, and the marginal benefits of informality decrease, with firm size, resulting in much lower rates of informality among larger firms compared to small ones (Perry et al., 2007; Loayza, 1996).

*Relationships between small firms and formal institutions, or the lack of such relationships, affect enterprise growth and expansion into higher value-added activities*

Size and the informality of enterprises may be inversely related in many situations.<sup>5</sup> In addition, relationships between small firms and formal institutions, or the lack of such relationships, affect enterprise growth and expansion into higher value-added activities (e.g. formal financial institutions can facilitate enterprise development). Nevertheless, size may be a more important focal point for analyses concerned with economies of scale and structural change, with informality being a separate, distinct factor which may limit the development of small enterprises within the broader context of inclusive growth. This is a potentially important research area: a better understanding of the relationship between enterprise development and informality, with informality and the scale of operation defined as distinct concepts.

<sup>5</sup> Some studies have found significant informality among large firms - e.g. Benjamin and Mbaye (2010) find this to be the case in francophone West Africa. In interpreting these findings, attention must be paid to the definitions used. In the Benjamin and Mbaye study, large informal firms, as distinct from formal firms, are defined in terms of tax evasion. This raises the question of whether the central issue for these large firms is informality per se (used in the same sense as informality applied to the very small scale self-employed) or tax evasion (with informality being used as a label for tax evasion).

Status in employment: risk and autonomy. The International Classification of Status in Employment (ICSE-93) provides a set of standard categories for classifying employment which are based on two criteria: (1) the type and degree of economic risk and (2) the type and degree of authority/autonomy that workers have. The ICSE system identifies five primary employment status categories: employees, employers, own-account workers, members of producers' cooperatives, and contributing family workers.<sup>6</sup> It is worth taking a moment to think more about the two criteria which undergird these categories - the degree of risk and the degree of authority or control. The degree of authority refers to the amount of control individuals have over their own work activities, the enterprises in which they work, and other workers in that enterprise. It is commonly assumed that the self-employed enjoy greater authority than wage employees. In contrast, the degree of risk refers to various dimensions of uncertainty associated with the employment arrangement, including attachment to the job and volatility in earnings. For example, because the earnings of paid employees are assumed to be specified by a contractual arrangement and not to depend on the revenues of the enterprise, earnings risk is assumed to be lower for employees in standard, formal jobs compared to the self-employed.

The concepts underlying the concept of status in employment can be used to characterize employment arrangements in ways that may be more helpful than a blanket label of 'formal' or 'informal', or through the use of the standard employment status categories. For example, vulnerable employment may be characterized by high risk and limited autonomy or control (i.e. a lack of choice). Forms of wage employment in which workers bear substantial risk and forms of self-employment characterized by a high degree of dependence (e.g. on buyers, suppliers, or intermediaries) both fall into the high-risk, low-control category. Social protection policy and regulations are often used to address issues of risk and dependency and this establishes a relationship between informality and employment status. Social protections help reduce risks and regulations are able to limit the actions of those with more power in dependent relationships. However, the concepts of economic risk and autonomy/control are distinct from the concept of informality. Again, this represents a potentially important area for research: describing the profiles of risk and control within existing and emerging employment relationships and connecting this analysis to the development of appropriate regulatory and social protection policies.

Taxation and the provision of public goods and services. One stream within the broader literature on informality focuses on the non-payment of taxes by informal enterprises. Such tax evasion is seen as the outcome of self-interested decisions - i.e. enterprises choose to operate informally specifically to evade taxes. Often, the analysis is not limited to tax evasion, but also considers the provision of public goods and services. If the benefits of public goods fail to reach informal workers, they may be more likely to avoid paying taxes (Gërxhani, 2004). A similar argument concerns social protections - according to these arguments, if informal workers have access to

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<sup>6</sup> Some indicators, meant to capture the prevalence of informal employment, are defined specifically in terms of status in employment. For example, the ILO defines 'vulnerable employment' to comprise own-account workers and contributing family workers.

non-contributory social protection schemes, there is an incentive to evade taxes, since there would be no reduction in social protection benefits and informal firms would have an incentive to free ride on the system (Levy, 2008). Widespread tax evasion will reduce government revenues and limit public investments, with adverse effects on economic performance (Loayza, 1996).

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Defining informality as synonymous with tax evasion generates a number of problems. Tax evasion among economic actors in developing countries takes on a range of different forms, not all of which would be linked to informality as commonly understood. For example, trade mispricing by transnational companies is a form of tax evasion associated with a sizeable loss of revenues, and yet these activities, and the

institutions responsible, are not generally treated as informal. Clearly, informality is a significant aspect of the broader institutional setting within which public goods are provided and government revenues mobilized. If the policy focus is on these issues, the effect of informality should be analyzed along with other factors determining the efficacy of public finance and investment. Conflating informality with tax evasion when the ultimate objective is to improve delivery of public goods and services would lead to partial solutions at best. More research is needed on how the provision of public goods can improve the quality of informal employment and how these investments can be financed through the better mobilization of resources, including, but not restricted to, informal enterprises.

### 3. Key debates and theories

A core dividing line between different theoretical perspectives on informality is the degree to which informal employment is assumed to be freely chosen and the extent to which it is assumed to be a outcome of constraints that limit opportunities and choice (Kucera and Roncolato, 2008). According to first view, the decision to work in the informal sector is the result of individuals choosing among alternative sources of employment. Workers move freely between formal and informal employment and they weigh the benefits of working formally against those of working informally, selecting the form of employment with the greatest net benefits (e.g., Maloney, 2004; Loayza and Rigolini, 2006). The voluntarist approach is very different from other theories of informality, in which informal employment results from a structural constraint. The most commonplace of these explanations argue that regulatory distortions in formal labour markets - such as minimum wage laws or collective bargaining agreements - keep labour costs artificially high and cause formal sector jobs to be rationed (Fields, 1975). Those who are unable to secure formal employment work informally. In this framework, it is common to see formal regulations as the source of labour market imperfections, but others have shown that efficiency wages and

turnover dynamics could produce a similar formal/informal dualism (Mazumdar, 1976; Stiglitz, 1974).

Recently, there has been an effort to synthesize these arguments into a single approach which recognizes some degree of heterogeneity in informal activities (Fields, 1990; Perry et al., 2007). In these hybrid frameworks, there is a low-end segment and a high-end segment of the informal labour market. Individuals voluntarily choose the high-end segment as an alternative to formal employment. Rationing of formal job opportunities and barriers to entering high-end informal activities result in a portion of the labour force having no choice but to work in low-end activities.

In contrast, other structural theories see informality as driven by the need to lower labour costs and protect profitability in a competitive global economy (e.g. Portes, et al. eds., 1989). For example, self-employed individuals working in the informal sector may be incorporated into global production networks as a source of low-cost labour. Similarly, the rollback of social protections in the face of competitive pressures leads to greater informalization. In these frameworks, it is the demand for informal labour, rather than the lack of demand in formal labour markets, which drives informalization.

In considering these theoretical approaches, it is useful to make a distinction between social protection and regulation. It is possible for individuals to lack social protection, but still be subject to regulation and public authority. For example, street vendors often face a range of regulations regarding how and where they can engage in trading and frequently are subject to harassment by municipal authorities (e.g. Roever, 2006). Lumping together regulations and social protections when analyzing the institutions influencing the dynamics of informal employment is not appropriate, and may create difficulties in defining the appropriate regulatory environment to support people's livelihoods.

In the frameworks discussed above, the constraints which limit choices are often restricted to labour market institutions. However, a broad range of constraints influences patterns of informal employment and the extent to which individuals are able to choose freely among economic opportunities. Gender-based constraints - including responsibilities for unpaid care and household work, social norms and gender roles, differences in women's access to and control over assets and finance, and unequal investments in the capabilities of girls and boys - limit women's choices relative to men's with regard to employment. There is evidence of gender segmentation within informal labour markets and a gender earnings gap in informal self-employment (Chen et al., 2005). This suggests that gender based constraints operate in informal labour markets, despite the absence of social protections and formal regulations. Factors other than discriminatory practices in wage labour markets determine gaps between women's and men's earnings.

Many theories of informality assume that barriers to entry into informal employment are low or non-existent. Indeed, the lack of barriers to entry may be taken as a defining feature of informal employment - i.e. in dualist models, formal employment is distinguished from informal employment precisely because there is limited entry into formal employment. However, some researchers have suggested that barriers to mobility exist between different categories of informal employment (Heintz and Posel, 2008). The existence of barriers to entry distinguishes high-end informal employment from low-end informal employment in the hybrid models discussed earlier. Enterprise size is also associated with differences in barriers to entry. In order for enterprises to take advantage of economies of scale, they often require access to assets, finance, or larger markets - all of which could constitute significant barriers to entry.

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A related, yet distinct, set of issues concerns whether informal activities should be perceived as a vibrant, dynamic set of activities which support livelihoods in developing countries when the formal economy fails to do so sufficiently (Hart, 1973; ILO, 1972). The alternative is to see informal activities as a low-productivity residual, providing subsistence for those excluded from better employment opportunities.<sup>7</sup> The choice between these two perspectives has important implications for how informal employment fits into national development strategies. Should policies aim to support informal employment and improve earnings and working conditions, with the aim of supporting broad-based economic development? Or should the long-run objective be to move people out of informal employment and into formal wage employment, cultivating economies of scale and high-value-added activities within the formal sector? These two strategies are not necessarily mutually exclusive - support of the informal sector could feed into long-run structural transformation. However, tensions exist between the role of informal activities as an essential source of employment and the possibility that widespread informality reinforces low levels of productivity, thereby holding back growth and preventing long-run improvements in the quality of employment.

In many of these approaches to understanding informality, the dividing line between formal and informal is clearly defined. Informal employment is either chosen as preferable to formal employment or the lack of formal opportunities consigns individuals to informal employment. In both cases, informal activities are clearly separated from formal activities. In reality, the relationships between formal and informal are more pronounced and complex. Some forms of informal employment, e.g. industrial outwork, are linked into international production networks that extend into the formal global economy. Domestic subcontracting arrangements may traverse formal and informal enterprises. Informal street vendors may rely on formal firms as suppliers

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<sup>7</sup> Earlier theoretical frameworks of dual labour surplus economies (e.g. Lewis, 1954) divided the labour force into those employed in a modern, high-productivity sector and those stuck in survivalist activities, although they did not use the term 'informal'. These conceptualizations of dualism remain influential.

(Skinner, 2005). In addition, many informal activities rely on the domestic market, the size of which depends on incomes from both formal and informal employment. Under these conditions, the growth of informal incomes depends, in part, on changes in income from formal employment - another formal-informal linkage (Mazumdar, 1976).

For these reasons, separating the economy into two distinct parts, a formal economy and an informal economy, may not result in a clear-cut division. The relationships between formal and informal activities, institutions, and workers are important to take into account when analyzing how the benefits of economic growth may be distributed. For these reasons, this paper has avoided using the terms 'informal economy' and 'formal economy'. Instead, the use of informal and formal has been restricted to describing enterprises, productive activities, jobs, and institutions, rather than separable spheres of the economy.

It is generally presumed that economic growth should be associated with a decline in informal employment. From cross-country data, there appears to be a negative relationship between the relative size of informal activity in the economy and per capita income (e.g. Loayza and Rigolini, Ihrig and Moe, 2001). In addition, there is some evidence that the rate at which informal employment expands tends to fall with economic growth (Heintz and Pollin, 2005). In addition, causation may run in both directions - with informality limiting growth, and slower growth contributing to informalization. The share of informal employment in total employment can increase even in countries with respectable rates of per capita GDP growth (Heintz and Pollin, 2005). This suggests that growth alone may not be sufficient to prevent an expansion of informal employment. The type of growth matters. Growth that does not generate sufficient formal employment opportunities for a growing labour force will cause the share of informal employment to rise. Similarly, competitive pressures may lead to patterns of growth which place downward pressures on labour costs, raising the demand for informal labour relative to formal labour. This too would contribute to rising informality.

The relationship between the rate of growth, the nature of growth, and informality represents an area in which more research is needed. Research in this area should go beyond simple correlations between growth rates and informality to understand the variations observed across countries. Has informal employment increased with growth in some countries and declined in others? And what factors may be responsible for these differences? In what ways does informality itself affect growth, either positively or negatively? As with all research on informality, the results will be sensitive to the definitions used. Moreover, limited observations on informality over time restrict the scope of research in this area and the selection of definitions for measuring informality.

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#### 4. Regional and country-level differences in patterns of informality

Different countries and regions exhibit distinct patterns of informality. Because of this, generalizations about the causes and consequences of informal employment should be approached with caution. For instance, many of the empirical studies of choice and mobility between informal and formal employment use examples from Latin America (Maloney, 2004; Bosch and Maloney, 2010; Levy, 2008; Fields, 1990). This body of research raises important issues regarding the dynamics of informal employment in the countries considered. However, there is no basis to assume that any lessons learned would necessarily apply to other regions, such as sub-Saharan Africa, South Asia, or Eastern Europe. Just as informal activities exhibit enormous diversity, there is no single archetype of patterns of informality that fits all countries and regions.

The publication of the ILO regional office, *Panorama Laboral*, provides detailed statistics on the nature of informal employment in Latin America and the Caribbean (ILO, 2011). In Latin America informal wage employment is often as important as informal self-employment in terms of the overall composition of informal activities. For women in the region, employment in paid domestic services performed in private households represents a significant share of informal employment, but this is often not true to the same extent in other regions. For younger workers (e.g. 15 to 24), those working in informal jobs are concentrated in wage employment. Informal self-employment is more common among older adults (Cunningham and Salvagno, 2011).

The Latin American situation contrasts sharply with that of sub-Saharan Africa. In many of the countries in sub-Saharan Africa, agricultural employment accounts for a sizeable share, if not a majority, of all employment. Therefore, studies of informal employment restricted to urban areas or non-agricultural activities will exclude a large number of individuals in very low-paid, vulnerable employment. In non-agricultural activities, self-employment frequently accounts for the largest share of informal employment (Heintz, 2010). Informal paid employees are less common although exceptions, like South Africa, exist in which informal wage employment is prevalent. Making a sharp distinction between agricultural/non-agricultural activities may also be unjustified. Individuals frequently engage in multiple activities and rural households may diversify their livelihood strategies to include both agricultural and informal non-agricultural employment. Furthermore, diversification into non-agricultural activities may exhibit seasonal patterns.

The patterns of countries in South Asia exhibit similar patterns to those in sub-Saharan Africa - e.g. the importance self-employment and agricultural activities - although women's reported labour force participation rates are significantly lower in South Asian countries. Nevertheless, some distinct forms of informal employment are relatively more common in this region. One example is industrial outwork - home-based subcontracted manufacturing activities which are linked into global production networks or supply chains. These arrangements represent subcontracted informal self-employment, characterized by significant dependencies. Much of this work is done by women. Although such arrangements exist in other countries, they tend to be relatively more common in South Asia. Because of their integration into global production networks, the dynamics

of such employment arrangements differ from other types of informal self-employment. A wide range of home-based work arrangements exist across all countries and regions, but not all home-based work is industrial outwork. Industrial outwork represents just one type of informal home-based work - specifically, a form characterized by subcontracting relationships.

The objective here is not to present a comprehensive typology of patterns of informal employment, but rather to make the case that distinct patterns exist and that analysis of informal employment needs to take into account these differences. Efforts to improve the quality of employment among informal paid employees, including those in domestic service, require a different set of policies and approaches than efforts aimed at the informal self-employed and informal enterprises. There is no single package of policies that can be applied across all countries.

## 5. Informality and inclusive growth

Employment represents one of the most important channels through which people participate in the economy and through which the economic benefits of growth are distributed to individuals and households. Insofar as informality is the outcome of decisions made in the face of structural constraints that limit choice, these constraints represent a barrier to inclusive growth. But informality - defined in terms of a lack of social, legal, and regulatory protections - may not be the only, or even the most important aspect of employment with respect to making growth more inclusive. As suggested earlier, the degree of risk and control (with control defined in terms of the range of choices available) may be more fundamental. Those that enter informal employment voluntarily and those that work informally because of limited opportunities are both placed in the category 'informal', but the degree of choice the two groups enjoy is very different. This is not to suggest that informality is unrelated to risk and control. Social protection policies may be designed to reduce risks among vulnerable workers, but even here the focus should be on designing appropriate forms of social protection based on actual sources of risk.

*Informality - defined in terms of a lack of social, legal, and regulatory protections - may not be the only, or even the most important aspect of employment with respect to making growth more inclusive.*

One possible way of evaluating how issues around informality should best be integrated into development policy and research is to determine to what extent access to social and legal protections represents a primary constraint on the ability of individuals to participate in and benefit from productive activities. In many situations, informality may contribute to the severity of other constraints, rather than representing an distinct, separable constraint. For instance, access to finance represents a constraint for many small-scale enterprises, and informality could curtail access even further (e.g. due to lack of formal accounts, a reliable credit history, or legal rights to land). However, in this example, the real barrier to improving livelihoods is exclusion from the services of financial institutions. The solution would involve finding ways of providing informal

enterprises access to credit, rather than necessarily focusing on informality per se. Part of the solution may involve creating new institutions, relationships, and practices which, by their very existence, make informal enterprises more formal.

In many respects, the structuralist/voluntarist distinction that defines so much of the thinking on informality is a limiting one. Individuals do make purposeful choices about their employment, taking into account household dynamics in addition to individual preferences. However, these choices are made subject to a range of constraints.

*We would expect inclusive growth not only to expand the number of choices available to individuals, but also the quality of those choices.*

Individuals with different endowments of wealth, income, education, information, and social connections face different constraints. Responsibility for dependents, both in terms of income support and nonmarket labour, imposes constraints on employment choices. As discussed, gender dynamics mean that women face different constraints than men. Constraints also vary across race, ethnicity, caste, and other social divisions. Inappropriate labour market institutions may also impose, rather than relax, constraints. The primary challenge is not to determine whether informal employment is voluntary or freely chosen. Rather, it is to identify the binding constraints on employment choices and to develop policies that relax these constraints and improve employment outcomes.

However, relaxing constraints on individual choice is not enough. Suppose an individual were free to choose between formal and informal employment, but decided to work informally. This does not mean that the informal job is a good one - only that it is preferable to the other options available. The quality of choices also matters. We would expect inclusive growth not only to

expand the number of choices available to individuals, but also the quality of those choices.

*The primary challenge is not to determine whether informal employment is voluntary or freely chosen. Rather, it is to identify the binding constraints on employment choices and to develop policies that relax these constraints and improve employment outcomes.*

Moreover, attention should also be paid to constraints on the ability of individuals to engage in collective action in order to improve their working conditions. There is no shortage of examples of collective responses to the limitations individuals face in their own employment situations. For example, pooling savings in rotating credit collectives is a common institutional response to individual cash flow

constraints. Similarly, pooling resources to purchase supplies, rent equipment, or market output can help individuals take advantage of economies of scale and to manage risks in ways that they, acting alone, would be unable to do.

The concept of inclusive growth requires analysis of how employment opportunities arise and change with the growth process. As discussed earlier, economic growth can be accompanied by an increase in informal employment. For some types of informal employment - e.g. informal wage employment or subcontracted self-employment - informality may support growth by reducing

labour costs and improving competitiveness. On the other hand, concentration of a large proportion of an economy's human resources in activities with low levels of productivity and dismal earnings will put the brakes on growth. In this situation, the challenge is to move labour out of low-quality employment into more productive activities. The process of long-run economic development has been associated with these kinds of structural changes. This could imply shifting people out of informal employment or the upgrading of informal activities, but it does not imply that reducing informality is necessarily the primary policy objective. Instead, the aim would be to develop policies which facilitate a more productive use of human resources in a way which expands the degree and quality of employment choices available to individuals. To the extent that exclusion from social protections and legal rights limit choices and mobility, a reduction in the proportion of people informally employed would constitute an important element of an employment-focused approach to inclusive growth. However, this does not suggest that 'formalization' must be a distinct policy goal within an inclusive growth agenda, even if informal employment decreases as a consequence of making growth more inclusive.

## 6. Research and Knowledge Gaps: The Nexus Between Informality and Inclusive Growth

This paper has reviewed different approaches to the concept of informality, discussed major policy and theoretical debates, and linked informality to inclusive growth. In so doing, a number of knowledge gaps and areas for future research were identified. In this concluding section, we summarize and expand on these areas for further research. Instead of presenting a shopping list of all possible research areas, the aim is to identify areas in which the gaps are widest and the potential value-added of new research is particularly strong. The introduction of the paper presented a definition of inclusive growth which will be used to frame this final discussion: inclusive growth is defined as growth that takes place in a context in which employment opportunities expand and improve, poor households' access to these opportunities increases, and inequalities are reduced. In addition, informality will generally be defined in terms of employment, enterprises, and activities which lack social, legal, and regulatory protections and, in the cases of individuals, social and legal rights. The discussion of research gaps will focus on four areas:

- The relationship between economic growth, economic development, and informality
- Barriers to mobility which individuals and enterprises face
- Understanding formal/informal linkages
- Public goods, informality, and the quality of employment

**The relationship between economic growth, economic development, and informality.** This issue was raised repeatedly in the course of the paper and it represents an area in which more research is needed. Within an inclusive growth framework, the relationship between informality and growth is particularly relevant. As discussed earlier, the overall prevalence of informality

appears to fall as per capita income rises. We also pointed out that there is some evidence of a negative correlation between changes in informality and economic growth: more rapid growth is associated with smaller increases (or reductions) in informality. However, research in this area is not definitive and significant cross-country variation exists. One interpretation of the unexplained variation is that the type of growth matters in determining trends in informality. In addition, causality runs in both directions: countries characterized by widespread informality may experience slower growth, when informal employment is concentrated in low productivity activities. This does not necessarily mean that a lack of social protection, for example, reduces growth (although this is a possibility), but rather that informality is correlated with forms of employment in which the scope for productivity improvements are limited.

This raises a number of relevant research questions for a policy agenda focused on inclusive growth. Little work has been done trying to explore the question of whether different types of growth have different effects on the quality of employment and informality. For example, given the reliance of many informal activities on the domestic market, we may hypothesize that growth which is strongly export-oriented will have different consequences for informal employment than growth in which the domestic market plays a larger role.<sup>8</sup> There are other aspects of the nature of growth which could be similarly explored (e.g. the extent of state involvement, the sectoral composition of growth, and the contribution of enterprises by size).

In addition, the channels through which growth affects informality are not well researched. If informality is defined in terms of a lack of social and legal protections, then a negative relationship between informality and growth implies that such protections should expand with growth - but how does this occur and when might it fail to materialize? One explanation could be that as firms grow, they may have an interest in expanding social protections in order to stabilize their workforce and encourage the acquisition of skills (i.e. formal job creation outstrips the growth of informal employment). A very different possibility is that growth may improve the bargaining positions of employees and their ability to put political pressure on the state in ways that enhance social protections. A third possibility, among many others, is that growth is associated with the expansion of the domestic market which allows small enterprises to take advantage of economies of scale that they could not achieve previously - resulting in a larger number of formal firms. Research into the channels through which growth may affect informality is underdeveloped and deserves greater attention.

Given the issue of mutual causality, it is also worthwhile turning the growth-informality relationship around and examining how the level of informality affects growth. It is often assumed that informal employment is low-productivity employment, and therefore informality drags down growth. However, this raises a number of questions. For example, does informality itself slow down growth or is low-productivity employment caused by factors correlated with informality (e.g. concentration in small-scale enterprises with little scope for up-grading)? It is well

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<sup>8</sup> This research area is not the same as an assessment of the impact of trade liberalization on informal employment

established that the allocation of labour across sectors and different activities has consequences for long-run economic development, but these relationships have not been fully explored in the context of informal employment and whether informality itself plays a role (i.e. in what ways does the lack of social protections constrain growth).

**Barriers to mobility which individuals and enterprises face.** We have defined inclusive growth as growth in which individuals from poor households can take advantage of new and better opportunities - including employment opportunities. Therefore, barriers which prevent individuals from taking advantage of economic opportunities represent a challenge to realizing inclusive growth. Throughout the paper, we have argued that individuals make purposeful choices about their employment, but under a number of constraints. The lack of opportunities represents one constraint, and the relationship between growth and employment opportunities is therefore a critical part of the story. However, other constraints can prevent people from taking advantage of opportunities which are created through the growth process. These constraints affect individuals (e.g. women unable to improve the quality of their paid employment because of their responsibility for unpaid care work) and enterprises (e.g. small enterprises unable to take advantage of a growing economy by upgrading their business because they lack credit).

*Barriers which prevent individuals from taking advantage of economic opportunities represent a challenge to realizing inclusive growth.*

We describe the constraints that prevent individuals from taking advantage of opportunities when they become available as 'barriers to mobility'. Mobility is defined broadly here to include labour market mobility (movement into better employment) and upward economic mobility (such as that associated with enterprise development). As discussed at length, structural barriers to mobility represent one possible cause of informality. A substantial body of research already exists which identifies constraints by estimating the determinants of earnings in informal employment. From this work, a number of the key constraints which informal workers face have been defined: skills and education, access to credit, assets (including land), and access to markets. Refinements to this research and the extension of this work to countries for which such analysis is missing will improve our understanding of these issues. However, there are a number of other areas under the broad heading of 'barriers to mobility' for which knowledge gaps remain substantial. They include:

Economic risk as a barrier to mobility. Discussions of informality often focus on social protections and mechanisms for managing economic risks. There is a need for more research on the ways in which various economic risks constitute a barrier to mobility and to suggest policies which help manage risks. For example, precautionary savings for emergencies may prevent the investment of those savings in enterprise development. Uncertain cash flows may prevent the self-employed from taking advantage of opportunities when they arise. Better measurement of these risks and research into the extent to which they prevent upward mobility is needed.

Transitions into and out of informal employment. Little is known about the transitions into and out of informal employment. The limited number of longitudinal studies that do exist suggest that there is a significant amount of movement between types of employment (e.g. Bosch and Maloney, 2010; Cunningham and Salvagno, 2011). However, the number of such studies is limited and tend to focus on a few middle-income countries (primarily in Latin America), in part due to issues of data availability. Clearly, more work is needed on a variety of research questions. To what extent is there mobility between different forms of employment? Is informal employment transitory, or of a longer duration? What determines the likelihood of transitioning into formal employment? Do poor households face different labour market trajectories in terms of individual mobility over time? In terms of conceptualizing inclusive growth as a dynamic process that plays out over individuals' lifetime, transition dynamics are of great importance.

Gender-based constraints and mobility. A range of institutions limit women's employment choices relative to men's, including social norms, household dynamics, and gender roles. Formal institutions, from banks to schools, also reflect gender biases that affect employment opportunities. Gender-based constraints are widely recognized and yet the exploration of these issues in the context of informality is relatively limited. Sex is included as a dummy variable in earnings estimations and women's informal employment is quite frequently tabulated separately. Nevertheless, the ways in which gender constraints affect women's employment choices in the context of informality needs to be examined in greater depth. For example, it is commonly assumed that women are concentrated in informal self-employment due to time use constraints, but much more analysis of time use and labour market data is needed to fully understand the extent to which this is the case and which factors are limiting women's choices.

Enterprise Upgrading and Upward Mobility. As discussed earlier, a significant amount of research exists on the determinants of enterprise earnings which identifies a number of common constraints - e.g. finance and markets. What is less clear is the process whereby very small-scale informal enterprises can significantly improve the scale, scope, and quality of their productive activities in order to raise earnings and productivity, and potentially support overall growth. The barriers to this kind of upward mobility of enterprises are poorly understood. To complicate matters, upgrading may not always be the answer. For some small-scale enterprises (e.g. street vendors or waste pickers), the possibilities for upgrading may be severely limited, in which case the appropriate policy focus would be to shift individuals into other forms of employment. As part of this larger research area, we need a better understanding of the relationship between enterprise development and informality. Research is needed on the potential for upgrading existing enterprises, so that informal enterprises can serve as a basis for growth, and, when upgrading is not feasible, on strategies to move individuals into better opportunities elsewhere in the economy.

**Understanding formal/informal linkages.** As discussed earlier, many conceptual approaches to informality tend to divide the economy into a formal sphere and an informal sphere. However, this separation can discourage a consideration of the multiple ways in which formal and informal

enterprises, jobs, and institutions interact. One possible consequence of a strict formal/informal dichotomy is that research into linkages between informal enterprises and formal enterprises is underdeveloped. For example, we know that many dependent relationships exist between the informal self-employed and formal firms (whether they are buyers, suppliers, or intermediaries). However, our understanding is limited when it comes to how the relationships between formal and informal firms, including power relationships, affect the distribution of earnings and the scope for upward mobility. As already discussed, there is some evidence that individuals move between formal and informal forms of employment, yet the details of these dynamics (why move?) are not clear. These relationships may be critical for understanding the connections between inclusive growth and informality. For example, does growth which primarily affects formal firms also improve conditions for informal enterprises through formal-informal linkages? Or, if growth is to benefit informal enterprises and workers, must policy explicitly target informal activities? The answers to these questions would help formulate growth strategies which would be more inclusive.

**Public goods, informality, and the quality of employment.** Two relationships between informality and public goods are often stressed in the existing literature. First, to the extent that informality lowers tax revenues, government's ability to invest in public goods is compromised. Second, informal activities often face constraints in terms of poor quality infrastructure - including roads, electricity, and water infrastructure. However, framing the analysis in these terms may be limiting. The public goods and services which have the possibility of supporting the livelihoods of informal workers frequently differ from the commonly cited categories. For example, the establishment of a buy-back center in Durban, South Africa, supported by the municipal government, for informal workers engaged in recycling activities helped improve overall working conditions (Chen et al., 2005). Basic interventions - the provision of sanitation facilities near marketplaces or access to urban spaces to facilitate orderly trading - represent public goods and services which make important contributions to the quality of employment.

In addition, getting informal enterprise to contribute to government revenues will be easier if those contributions were seen to support investments and services which improve employment

*Basic interventions - the provision of sanitation facilities near marketplaces or access to urban spaces to facilitate orderly trading - represent public goods and services which make important contributions to the quality of employment.*

conditions (Gërkhani, 2004). The appropriate provisioning of public goods to improve employment and developing financing mechanisms which include informal enterprises represent important areas of intervention, but designing good policy requires better information. Which types of public goods would make the biggest difference to large groups of informal workers? How can the provision of public goods be used to improve the mobilization of public resources from

informal enterprises? An inclusive growth strategy will necessarily include support for various types of public investment and such investments will need to be financed somehow. Finding

effective ways of integrating informal enterprises and activities into this process requires additional, targeted research.

The research questions and themes highlighted in these four areas are not meant to be comprehensive. However, they do represent areas for research on informality which can be directly linked to an inclusive growth agenda and for which there are significant knowledge gaps. There are significant challenges for pursuing some of these research areas. For instance, growth is a dynamic process by definition, and yet good, comparable data on trends in informality is limited. This makes analyzing growth-informality relationships difficult. In addition, there are questions of process which also require attention - issues of voice, participation, and social dialogue for informal workers. Conventional approaches to these issues may not apply; to give an example, social dialogue between the informal self-employed and municipal authorities may be more important than traditional approaches to social dialogue which presume an employer-employee relationship.

More generally, this paper has attempted to provide an overview of the concept of informality, to raise key themes and debates, and to relate the various streams of thought on informality to the issue of inclusive growth. While our understanding of informality has improved over the years, with better data and new analysis, much more needs to be known about the relationship between economic development and employment in order to make economic growth more inclusive. This short review has attempted to outline how questions of informality fit into this larger picture.

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