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## **MINDSETS, TRENDS AND THE INFORMAL ECONOMY**

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# Mindsets, Trends and the Informal Economy

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## Abstract

The object of this paper is to complement the “politics trumps economics” theme of this volume by exploring how policy mindsets influence policy making, and how they tend to persist even in the face of counter trends in reality. I first of all develop the history of economic thought and economic policy making on informality, to establish the route through which we came to be where we are today. I then present the main global trends on informality and discuss some possible explanations for them. In light of this discussion, I then turn to policy and most importantly, how to change the mindset of those who formulate and implement policy on informality.

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## 1. Introduction

The informal economy comprises those economic activities which are beyond the purview of the state because they lie outside its framework of laws, regulations and protections. A small proportion of these activities are illegal, but mostly they are activities which are simply not covered by the state's rules and regulations. The informal economy is of great concern to policy makers the world over, and Indian policy makers are no exception. The core economic reasons for the concern are the strong association of informality with poverty and with low productivity. But the roots of recent pre-occupation with informality lie in the tension between two opposing forces. One of these is a historical policy mindset built on the expectation that informality will decline and disappear with development. The other is a global trend which shows informality to be not declining as fast as might be expected with economic growth, and indeed in some cases not declining at all but increasing.

The object of this paper is to complement the “politics trumps economics” theme of this volume by exploring how policy mindsets influence policy making, and how they tend to persist even in the face of counter trends in reality. I will first of all develop the history of economic thought and economic policy making on informality, to establish the route through which we came to be where we are today. I will then present the main global trends on informality and discuss some possible explanations for them. In light of this discussion, I will then turn to policy and most importantly, how to change the mindset of those who formulate and implement policy on informality.

## 2. Frameworks and Mindsets

There are two main historical sources of the current policy mindset on informality—the academic and the administrative. But these two strands are interwoven with each other. The early academic and analytical literature of development economics is dominated by “dual economy” models, where the dualism is modeled as being between a “modern” (or capitalist, or industrial, or urban, or formal) sector and a “traditional” (household enterprise, or agricultural, or rural, or informal) sector. The modern sector is the one which is governed by the laws of the state.

The details vary, but a central proposition, for example in the famous Lewis “surplus labor” model of development, is the tendency for the modern sector to grow relative to the traditional sector during the process of development.<sup>1</sup> The empirical support for this is often provided by ranking a cross-section of countries by their per capita income and noting that measures of industrialization, urbanization, formalization, etc. increase with income. These models and these snapshot stylized facts across countries are so ingrained in our thinking that measures of industrialization, or urbanization, or informality, etc. are sometimes used as a measure of development itself. The mindset is thus that informality should decline into insignificance as development takes place and as per capita income rises.<sup>2</sup>

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<sup>1</sup> Lewis (1954)

<sup>2</sup> Ghani and Kanbur (2012)

A different but related part of the academic literature is represented by the strand which owes its beginning to the classic paper by Harris and Todaro (1970). In this perspective the economy is once again divided into two sectors, a formal sector which is affected by a range of government regulations, and an informal sector which is not. In the specific context of the labor market, for example, the formal sector has a government enforced minimum wage which is set above the competitive level. This reduces labor demand in the formal sector, with the excess supply of labor moving to the informal sector, which does not have any labor market regulation. Competition clears the informal labor market at a lower wage. Thus the informal sector represents the ideal of a competitive labor market, while the formal sector labor market is “distorted” by government interventions. The policy stance emerging from this perspective focuses on deregulation in the formal sector in order to reduce the size of the informal economy.

As a final example of the analytical mindset in relation to informality, consider the line of argument attributed to Hernando de Soto (2003), reflected for example in the report of the United Nations High Level Commission on Legal Empowerment of the Poor (United Nations, 2008). Here the main issue is highlighted as the lack of formal legal frameworks in the informal economy—indeed, informality is defined as the lack of such frameworks. The policy conclusion is an attempt to make the informal into the formal by extending the reach of formal structures into areas such as urban slums. A major criticism is that such attempts simply try to translate or implant formal structures into the informal setting without a full understanding of all the repercussions or the operation of the informal economy.<sup>3</sup>

The administrative mindset on informality has somewhat more complex roots. It is best illustrated by a strand of the dual economy literature which goes back to colonial times. Indeed, the term “dual economy” was coined by the Dutch anthropologist and colonial administrator J. H. Boeke in his characterization of the economy of the Dutch East Indies.<sup>4</sup> The distinction here was between those activities that fell under the purview of colonial rules and regulations, and those activities that were beyond the legal and administrative reach of the colonial government. My reading of the colonial administrative literature brings to mind the notion of a wall which separates the formal from the informal.<sup>5</sup> On this side of the wall is the well-ordered colonial state, subject to a set of laws and regulations, managed by its administrators and officials. On that side of the wall is the (mostly native) informal economy, ill understood and misunderstood by colonial policy makers. It is perceived to be chaotic, disorganized, with criminal elements.

The colonial yoke has been lifted but not the mindset. Post-colonial administrators the world over, particularly at the local level, appear to have the same mindset as their colonial predecessors. Informality is a symbol of underdevelopment, a nuisance to be swept away and kept out of sight in the modernizing path of the national economy.<sup>6</sup> This obviously meshes conveniently with the analytical mindset which sees informality as in any case dwindling with development.

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<sup>3</sup> Basu, Chau and Kanbur (2011)

<sup>4</sup> Boeke (1953)

<sup>5</sup> See Basu, Chau and Kanbur (2011) and Ghani and Kanbur (2012)

<sup>6</sup> Guha-Khasnobis, Ostrom and Kanbur (2006)

### 3. Levels and Trends

The second set of points I wish to make relate to the basic global facts of informality. This requires us to first delve a little into the somewhat technical matter of measurement of informality. While the measurement of urbanization, or of industrialization, is not without its difficulties, these pale into insignificance compared with the issues raised by the measurement of informality.

Starting with the basic conceptualization that an informal economic activity is that which is outside the framework of the state's laws, regulations and protections, the question is how we translate this into a measurable entity to which the national machinery of statistical measurement can be applied. This requires us to specify the particular laws and regulations relative to which formality or informality is to be identified. One route is through economic enterprises, and applying the filter of those enterprises which are private unincorporated enterprises, "that is, enterprises owned by individuals or households that are not constituted as separate legal entities independent of their owners" (ILO, 1993, paragraph 5). But the definition of incorporation can vary from country to country, and often the measurements available turn out themselves to be a function of the laws in place.

A case in point is the distinction between the "organized" and the "unorganized" sector in Indian manufacturing, which is often used interchangeably with the distinction between "formality" and "informality" in the Indian context. India's Factories Act of 1948 requires all manufacturing enterprises with 10 or more workers (20 or more workers if the enterprise does not use electricity) to register with the authorities and to implement certain health and safety and other regulations. The registration then provides a count of such enterprises, and can be used as a measure of the size of the "organized" (or formal) sector in manufacturing.

However, such clean cut definitions, emerging straight out of the rules and regulations themselves, are not necessarily available in many or even most countries. In addition, there are criticisms of such an enterprise based perspective. An alternative, worker based, perspective is to ask if a worker has or does not have employer provided security of different types. Recent approaches to informality have adopted this broader definition. For example, India's national Commission on Employment in the Unorganized Sector (NCEUS) states the broadening as follows:

"The informal sector consists of 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 workers consist of those working in the informal sector or households, excluding regular workers with social security benefits by the employers, and the workers in the formal sector without any employment and social security benefits provided by the employers." (NCEUS, 2008, p. 2). These conceptual and statistical intricacies, of defining and measuring informality, have led to a large academic and technical literature. This is not the occasion to go deeper into these issues. Especially when it comes to cross-country comparisons and trends, a number of compromises have to be made in order to develop data series (Charmes, 2012).

What, then, is known about global patterns of informality? Rates of informality, the fraction of the total labor force employed in the informal economy, vary greatly across the world. Latin America rates are relatively low, in the 40%-50% range, while African rates are higher, in the 60%-70% range. South Africa is well known to be an anomaly in Africa, with rates in the 20%-30% range, depending on the exact measure used. South Asia has the highest rates of informality in the world. India, for example, has rates in the 80%-90% range.<sup>7</sup>

What about trends in informality? A recent comprehensive study, Charmes (2012) presents the following summary:

“In average for the [North Africa] region, the most recent period is characterised by a huge increase of employment in the informal economy, growing from 47.3% at the beginning of the 2000s up to 58.1% at the end of the decade....For sub-Saharan Africa....the figures for the region give an image of a continuously growing informal economy (from more than 60% in the 1970s and mid-1980s, to more than 70% at the end of the 1980s-beginning of the 1990s and more than 80% at the end of the 1990s), until the years 2000s, which seem to be characterised by a decrease.... In Latin America, employment in the informal economy seems on the rise, increasing from 54.2% at the end of the 1990s up to 57.7% at the end of the years 2000s.... In Southern and South-Eastern Asia, employment in the informal economy is stabilised around 70% of non-agricultural employment....ranging from 41.1% in Thailand to 84.2% in India and 86.4% in Nepal....Lastly, transition countries are making their way out of their former administered-centralised-wage economies and they see their share of employment in the informal economy....increasing little by little from 20.7% at the beginning of the years 2000s, up to 27% at the end of the decade.”

Thus the global picture is mixed, with some regional variation, but overall it would be fair to say that there is not a strong tendency for informality to decline, as would be predicted by the academic textbooks, and as expected by policy administrators. Country specific work for India largely confirms the sluggish decline, if not an actual increase, in informality despite dramatically higher growth rates compared to historical experience.<sup>8</sup>

What explains this persistence of informality in the face of economic growth in the last quarter century? There are two main candidate explanations which are debated by analysts. The first explanation is “regulation.” It is argued that informality is caused by excessive regulation in the formal sector, which creates incentives for economic activity to operate outside the purview of regulations—informality, in other words. But even if the presence of regulation could explain the *level* of informality, for it to explain *increases* in informality the regulatory burden would have had to have *increased*. But, in fact, it is well appreciated that in the last two decades of liberalization, the regulatory burden has if anything *decreased*. The regulation based explanation of increasing informality is thus weak at best.

The second main candidate explanation is to do with fundamental trends in technology and trade which have reduced the employment intensity of growth in the formal sector. The “jobless growth” phenomenon means that the formal sector cannot provide employment for a

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<sup>7</sup> Jutting and de Laglesia (2009) and Ghani and Kanbur (2012).

<sup>8</sup> Ghani and Kanbur (2012), Jutting and de Laglesia (2009)



growing labor force, which then has to go into either open unemployment or the informal sector. The technology/trade explanation seems to me to be a more plausible explanation for trends in informality. But if one accepts this then, since the forces shaping technology and trade are unlikely to reverse in the next two decades, we are also forced to accept that informality is here to stay. Far from receding as a result of development, the very nature of current development means that it will increase. A recent OECD report asked the question in its title: “Is Informal Normal?” The answer it gave was a definite “Yes”.<sup>9</sup>

#### **4. Tensions and Responses**

When the irresistible force of increasing informality meets the immovable object of current analytical and administrative mindsets, tensions arise which are reflected in policy schizophrenia. Different parts of the government end up doing different, contradictory, interventions. Sometimes, even the same part of government gives with one hand and takes away with another. The result is that the government as a whole shows policy incoherence, and ends up giving mixed signals.

These are phenomena we see around the world. In India, for example, the government has introduced a plethora of schemes to support workers in the informal economy, including training schemes, support for saving and investment by small operators, etc. However, at the same time, cities have become enamored of the “city of the future” label, with a mindset which sees the informal sector as something of a nuisance in achieving this goal. The city of Ahmedabad has designated some of its new roads “modern” roads, along which no street vending is to be allowed. Cities and governments are also vying to stage international events—the Commonwealth Games in the case of India’s capital, Delhi. The new stadiums and the flyovers lead to huge displacement of informal activities, with inadequate and inappropriate allocation of new space for these activities. In the rush to become what they think Singapore looks like, cities in the developing world are trying to sweep away the informal economy. But the global trends identified in the previous section suggest that this will ultimately be unsuccessful. Indeed, recent research seems to suggest that urbanization goes hand in hand with informalization (Ghani and Kanbur, 2012).

There is a plethora of technical issues which can be discussed in design of policy to address the needs of the informal economy. Examples include the extension of financial services, the development of skills through training programs, better infrastructure for small scale enterprises, and so on. However, in my view a central problem in addressing informality goes back to the policy mindset which on the one hand views the phenomenon as being “on the other side of the wall” and on the other hand as being “on the way out” since formalization is expected to increase during the process of growth and development. But the informal economy is here to stay, at least for quite a while, and as the name suggests it is indeed part of the overall economy. Its success and development is essential for overall economic development and for poverty reduction.

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<sup>9</sup> Jutting and de Laglesia (2009)

Policy makers and policy implementers are of course part of the formal economy. Their own lives are governed by rules, laws and regulations which are framed by the state. Their economic life has a regularity and a stability guaranteed by the state. This is very different from life in the informal economy. This difference is captured very well by Keith Hart, the anthropologist credited with coining the term “informality” in the 1970s, and with the early development of the concept, based on his work on the slums of Accra, the capital of Ghana in West Africa:

“The main message...was that Accra’s poor were not “unemployed.” They worked, often casually, for erratic and generally low returns; but they were definitely working... Following Weber, I argued that the ability to stabilize economic activity within a bureaucratic form made returns more calculable and regular for the workers as well as their bosses. That stability was in turn guaranteed by the state’s laws, which only extended so far into the depths of Ghana’s economy. “Formal” incomes came from regulated economic activities, and “informal” incomes, both legal and illegal, lay beyond the scope of regulation. I did not identify the informal economy with a place or a class or even whole persons. Everyone in Accra, but especially the inhabitants of the slum where I lived, tried to combine the two sources of income. Informal opportunities ranged from market gardening and brewing through every kind of trade to gambling, theft, and political corruption.” (Hart, 2006, p. 25).

The irregularities and uncertainties of the informal economy contrast sharply with the regularities and certainties of the economic lives of those who make and implement policies which affect them, and this disconnect is reflected often in policies and interventions. A good example, almost universal, is the ubiquitous requirement in the formal economy to establish (i) proof of identity and (ii) proof of residence for a whole host of economic interactions, particularly in the financial sphere. Proof of identity is required to be done through documentation like passports, driving licenses, voter registration card etc. Proof of residence is more problematic, requiring in some cases documents such as three consecutive utility bills with the name of the person on them. This is clearly not possible for those living in slums renting a room in a building from a landlord, and yet these are often the documents that are required.

Yet another example of the disconnect between the economic lives of policy makers and those for whom they make policy is provided by the thorny question of street vending and urban space. Loitering and vagrancy laws are often used by the police, at the behest of local residents, to clear away street vendors from public spaces. Street vendors are seen as dirtying clean spaces and obstructing living spaces in various urban neighborhoods. But street vending is the major form of livelihood for many in the informal economy. Thus we see the almost daily drama of groups of informal traders being moved on from one place, only to congregate in another and perhaps eventually cycling back to the same place when the attention of the police is elsewhere. In the process an entire class of economic activity is criminalized.

The daily drama is turned into a mega crisis when nations and cities host major international events, like the Commonwealth Games in Delhi, the World Cup in South Africa, or the World Cup and the Olympics in Brazil. “Beautification” programs in preparation for an event that lasts a few weeks lead to the displacement of thousands of informal sector workers from their normal place of trading and work. A different but conceptually similar crisis occurs

when the work of garbage pickers is displaced by formalized mechanisms with contracts given to big companies. The policy mindset is such as to always view this move favorably, as being towards modernity and formality.

How can this mindset, which is deeply rooted in our academic, analytical and administrative roots, be changed? Enhanced technical analysis which highlights the true nature of the informal economy, its challenges and its contributions, and the causes behind global trends in informality, will help of course. But changing the mindset will need more. In my view it will require removing, or at least reducing, the disconnect from the realities of the lives of policy analysts, policy makers and policy implementers on the one hand, and lives in the informal economy on the other. I turn now to this issue.

The disconnect discussed above in the context of informality is part of a wider disconnect between the poor and those who analyze, formulate and implement policies on their behalf. As Robert Chambers famously observed:

“...it would seem that it is we the professionals, the powerful and the influential, and those who attend roundtables and summits, who have to reconstruct our reality, to change as people...” (Chambers, 1995, pp. 203-204).

I have written extensively elsewhere about the nature of this disconnect (Kanbur, 2011, 2012; Bali, Chen and Kanbur, 2012), with a particular focus on what to do about it. The key element, I have argued, is to provide an insight into the lived realities of the lives that will be affected by policy, through what are known as “immersions” or “exposure and dialogue programs” (EDPs). Eyben (2004, p. 2) characterizes these as exercises:

“...designed for visitors to stay for a period of several days, living with their hosts as participants, as well as observers, in their daily lives. They are distinct from project monitoring or highly structured ‘red carpet’ trips when officials make brief visits to a village or an urban slum....”

An account of such exercises carried out by a group of academics, activists and policymakers is provided in Bali, Chen and Kanbur (2012). The academics were economic analysts mainly from Cornell University. The process, of which I was a part, involved this group spending a few days and nights living with and working with those who make their living from the informal economy. The EDP was conducted in India (twice), South Africa (twice) and Mexico (once), facilitated by local civil society organizations who worked with the informal economy. In India we worked with the Self Employed Women’s Association (SEWA). After the exposure to the lives and working conditions of our host ladies from SEWA, there was a period of dialogue where the conventional technical and policy issues were discussed, but this time framed by the lived experience of the informal economy itself. These discussions were written up, and published in Bali, Chen and Kanbur (2012)

The impact of the EDP on the outside participants was immense. As an independent evaluation of the process noted:

“Without exception, the Cornell economists all said that their time in the host households and their discussions with informal workers about their lives had given them a deeper understanding and had led to many new questions for debate in the subsequent dialogues and for later analytical work.... One economist, from a developing country, who felt he knew his own country well and was therefore sceptical about whether the EDP would provide him with anything new, said: “I now truly believe that there is so much that researchers can get out of these interactions, and it breaks down the hierarchies that we all operate with.” (Addison, 2012). Reports of such “immersion” exercises carried out by a number of agencies invariably point to the sensitization of outside participants to the ground level realities of life in the informal economy in a way that makes it unforgettable and leaves an indelible mark on future analysis and interventions. A special issue of the journal *Participatory Learning and Action* (2007) is devoted the topic and records the experiences of a wide range of agencies.

A number of international development agencies, including the World Bank, have experimented with such immersion exercises. What is interesting, and perhaps surprising, is that they have not really been tried by developing country governments for their officials. My personal experience, when I have suggested the exercise in different settings, is that the greatest resistance does indeed come from developing country officials. These responses echo those which Ruparel (2007, pp 39-40) refers to in the context of the NGO Action Aid:

“The usual reason for not participating is: ‘I don’t have the time.’ This usually means: ‘I can’t, or won’t, make this my priority for my time.’ We manage to make time for workshops in capital cities and for training courses, but we find it difficult to make time to spend with poor people, building relationships with them, and really listening to the voices that we don’t usually hear....Another reason given for not doing immersions is: ‘I come from a village, I don’t need to do this.’ While it is often the case that staff have such a background, an immersion offers an opportunity for them to stay with different communities that don’t know them, their roles, and their status.”

The resistance from officials, which is particularly marked in government ministries and agencies, is itself a reflection of the disconnect between the formal and the informal. EDPs, or immersions, are a tool to break through this disconnect, in the interest of better informed formulation and implementation of policy. As I have argued elsewhere:

“A central finding emerges from these and other experiences. Those who have experienced immersions are their greatest supporters. Those who have not are more likely to be skeptical. This skepticism has the potential to lead to a bad equilibrium where immersions are not done because they are not done. The only way this equilibrium can be broken is through outside action—for example, by a mandatory requirement from their management that all staff in all development agencies, whether official or non-governmental, undertake an immersion at least once in their career and preferably at key points in their career such as at appointment and promotion. Indeed, participation in an immersion in the current position could be made a basic qualification for promotion. I can of course see the objections to this, that it becomes yet another box-checking exercise on the career ladder. But we have such box-checking all over the place. For example, having taken certain courses, or attended certain seminars, are indeed often requirements for even being considered for promotion within these agencies. I can think of

worse forms of box-checking than that staff in a development organization actually have spent a few nights living with those whose lives the organization seeks to improve.” (Kanbur, 2012).

## **5. Conclusion**

I present the argument in this paper as a complement to the theme that “politics trumps economics.” The argument might be summarized as “mindset trumps trends.” Not forever, of course. Eventually reality must make itself felt, the only question is how quickly, and how effectively we can respond. I have argued that a mindset that sees informality both as “on the other side of the wall” and “on the way out” is confronting the reality that the informal economy is not declining and is a normal part of the economy. Thus the association of informality with poverty and low productivity need to be confronted directly. However, attempts to do so, well intentioned though they might be, are impeded by the simple fact that policy analysts, policy makers and policy implementers are themselves part of the formal economy and thus tend to operate in that frame. The analyses conducted, the interventions proposed, and their implementation, bear the hallmarks of that mindset. There is no simple answer to this conundrum, but I have made a particular proposal, based on the experience of EDPs and immersions. It is that analysts, policy makers and implementers should get some exposure to lives in the informal economy. This is not without its own shortcomings, and it is not a panacea.<sup>10</sup> But it is a start, and a start is what we need.

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<sup>10</sup> The shortcomings, and design responses to them, are discussed in Kanbur (2012)

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