

The Informal Economy in Developing Countries as an Avenue For Sustainable Development.

A Policy Brief



(WIEGO, 2015)

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Executive Summary

The Informal Economy provides a unique avenue for many developmental issues to be addressed through policy. The traditional approaches that have attempted to address the Informal Economy lack the nuance and innovation necessary to be effective and often follow a punitive and restrictive narrative that does not acknowledge the potential of the sector. This brief highlights how the effective management of the informal economy, supported by specific and effective policies can contribute greatly to the development of small economies, gender equality and workers' rights.

Background of Issue

According to the International Labour Organisation (ILO), 2 billion people, which is approximately 60% of the world's workforce, are part of the informal economy at least part time (ILO,2018). While the sector has often been regarded as a non-productive sector of a country's economy, new research has shown that not only does the informal economy contribute significantly to countries' GDP, but they also provide non-traditional avenues to tackle global issues such as economic and gender inequality.

What is the Informal Economy?

“The informal economy refers to all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements.” (ILO, 2024)

The informal economy exists globally, but significant differences are present between its existences in the Global North and South. The informal sector in low and middle income countries (typically in the Global South) is substantially greater than in developed countries in the Global North. This disparity is not surprising, as the informal economy is most prevalent in countries with low employment rates, high levels of poverty and limited resources.



(Fleck, 2023)

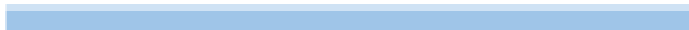
An effective analysis of the informal economy requires a nuanced understanding of the social and economic implications of the sector. The globalised and rapidly advancing technological nature of the modern market has created huge gaps of wealth and power between countries. Large and historically wealthy countries are better equipped to compete on the world market than the small or historically exploited nations. This creates a cycle of exploitation and inequality that is continually perpetuated in the global market.

Typical attempts to ‘develop’ low-income countries have followed the outline set by these larger and more powerful states, much to their own detriment. In these attempts, the informal economy has often been treated as merely a symptom of the poverty and underdevelopment of the nation which is sought to be eradicated. This approach lacks the nuance and innovation that this brief hopes to propose.

The informal economy supplies millions of vulnerable people with the ability to provide for themselves and their families every day. In reality, the informal economy poses a great opportunity for low-income countries to encourage the development of industry, trade and entrepreneurship which will undoubtedly increase economic activity within the country. Ofcourse, the informal economy as it exists in most low-income countries is not in a state where this can be effectively achieved. This is a result of poor management and the use of a one-size-fits-all traditional approach that has proven ineffective.

The Informal Economy and Sustainable Development

SDG No. 8 Decent Work and Economic Growth



The Informal Economy presents a very practical avenue to support economic growth within developing countries. The sector is most often critiqued for its implications on economic development and has traditionally been viewed as a hindrance to growth within countries as the informal nature of the sector allows for unregulated goods and services to be sold without the payment of taxes and other statutory fees that surround formal businesses. Despite this, recent studies have revealed that most governments of developing countries have already recognised that the informal sector, while not directly paying business related taxes, creates income for a large population which contributes to indirect forms of taxation such as Value Added Tax (VAT). In fact, research has shown that there is a correlation between countries with a large informal economy and increases in indirect taxes, which highlight policies that have already addressed this issue (Castaneda and Doyle, 2019).

Research has also shown that the informal sector contributes significantly to the GDP of low income countries. While the unregulated nature of the sector makes it difficult to quantify its activity, research from the International Monetary Fund (IMF) states that the informal economy contributes to approximately 35% of the GDP in developing countries (IMF, 2021).

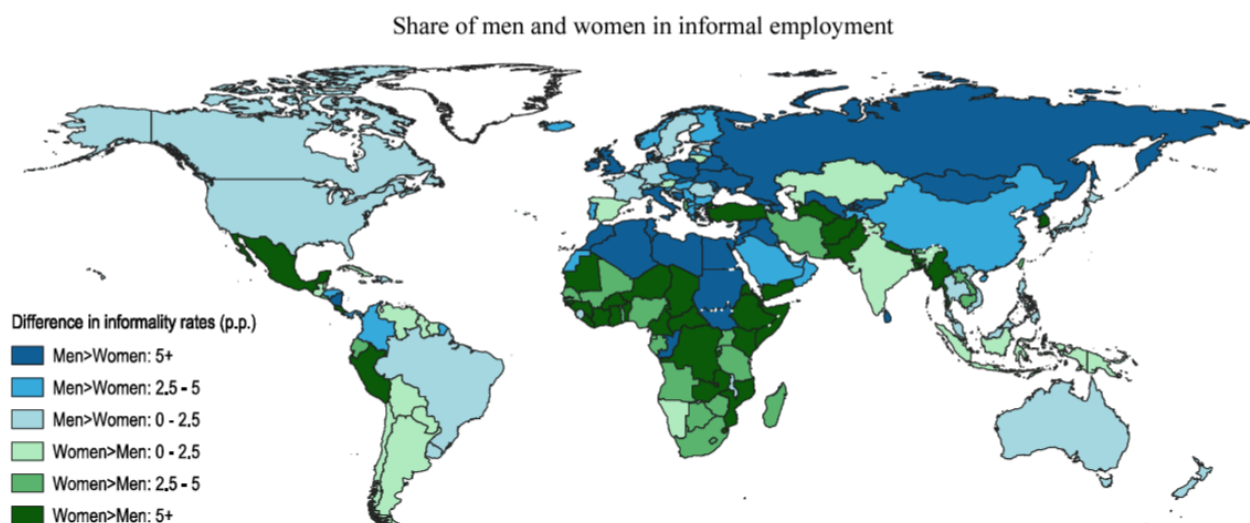
As sustainable development is at the forefront of the international agenda, the informal economy provides a useful opportunity to achieve its goals. The effective management of the informal economy has the potential to promote decent work, which is a major goal as stated by the United Nations. The informal sector comprises a large percentage of the global workforce.

Unfortunately, the current state of employment within the informal economy poses a serious issue in terms of the quality and security of the work being done. According to an IMF report, “85% of all informal workers are in precarious employment”(IMF, 2020). This means that people working in the informal sector are subject to poor working conditions, lack of social security and unfair compensation (ILO, 2010). Rather than policies that focus on the elimination of the informal sector, a target of innovative policies that are specifically tailored to the informal economy can provide better levels of protection for informal workers who make up a significant portion of the global workforce.

SDG No. 4 Gender Equality

The Informal Economy also serves as a unique opportunity to address gender inequality in developing countries. The IMF states that 58% of all employed women globally work in the informal economy and are overrepresented in a majority of countries especially in the Global South (IMF, 2021). As the precarious nature of informal work has already been established, it even further highlights the levels of gender inequality present within developing countries. While informal work allows for employment of such a large percentage of women, the OECD reports that they are also the lowest paid in the sector (OECD, 2019). As such, there needs to be a multi-level policy approach that both supports the development and formalisation of the informal economy to encourage female employment, but also management that ensures greater levels of protection and equality within the sector.

Women are over-represented in a majority of countries' informal workforce.



Source: (ILO, 2018)

Evaluation of Established Approaches

There are four primary policy approaches that have attempted to address the informal economy. (Chen, Jhabvala and Lund, 2002).

1. **Dismissive Policy** tends to ignore the existence of the informal economy altogether, and diminishes the role of a large percentage of developing populations that work in the sector.
2. **Punitive Policy** attempts to eliminate the informal economy through a variety of processes, this approach is often premature in nature and does not acknowledge the importance of a gradual approach in development.
3. **Restrictive Policy** seeks to contain the Informal Economy, preventing its expansion or development in any sense.
4. **Promotive Policy** attempts to encourage the development of the Informal Economy.

This policy brief recommends that a promotive policy is most effective in developing countries. It should be made clear that while a promotive policy supports the development of the informal economy, the main goal of this policy approach is to support the formalisation of the sector through its development.

A Case Study of Dismissive Policy

Trade Liberalisation in India

In 1991, India took on the economic policy of trade liberalisation, with the hopes of supporting its economic development. This policy consisted of several measures which reduced barriers to trade within the country, including removing and lessening tariffs and allowing more foreign imports into the country. This policy was held for around two decades, losing prominence after 2010 and was widely regarded as a successful measure in opening up India's trading with the world (Alessandrini et al., 2009).

In 2011, India's informal sector comprised 82.6% of the workforce and by 2017 the figure grew to 85.5%. This policy of trade liberation was dismissive towards the informal economy of the country, and did not anticipate the potential effects that it may have on the sector. In fact, it was found that the policy had serious effects on the informal economy and gender equality within the Indian workforce.

Research has identified that India's trade liberalisation policies adversely affected women as firms tended to substitute

*"In spite of rapid rates of economic growth since the 1991 reforms, the informal sector has been a persistent phenomenon in India, leading to **significant policy concerns on the lack of inclusivity of economic growth.**" (Sen, 2016)*

female workers for male workers when exposed to global competition. This contributed to more women joining the informal labour force as a result (Banerjee and Veeramani, 2017, p.1). As well as this, groundbreaking research carried out by a United Nations team in 2010 revealed that policies of trade liberalisation actually increases the prevalence of the informal economy (Fugazza and Fiess, 2010).

Potential Solutions



This policy approach proposes that the rights of informal workers should be better protected and that a development of informal businesses should be supported through the following measures.

- **Labour Market Reforms-** The adjustment of minimum wages to allow for greater employment in the formal sector can play a significant role in the reduction of precarious work, as formal firms would be able to afford more employees (Sabatini, 2021). However, there are certain complexities in this policy approach that are often overlooked and may contribute to its ineffectiveness. In most developing countries, there is often insufficient monitoring of the formal sector which prevents this policy from being actually implemented (Kar, 2016). Therefore, alongside this measure of labour market reform, measures must be put in place to establish increased monitoring of the formal sector, to allow for the policy's effectiveness. Additionally, while this measure may decrease the size of the informal sector, it is not sufficient as a stand alone policy as it is unable to independently address the entirety of the informal workforce. As such, this policy must be implemented in congruence with other policies for a comprehensive approach.
- **Labour Laws and Standards-** In order to address the issue of 'precarious work' within the informal sector, policies must be created that focus directly on informal employment and the protection of informal workers. As most developing nations lack monitoring and evaluation in the formal sector, it is well established that monitoring of the informal economy is virtually non-existent (Durham University, 2018). This enables this 'precarious work' to flourish, as there is no accountability within the sector. Simple policy approaches that establish and enforce labour laws and standards will address this issue. A downside of this policy is that it will contribute to greater costs by the government to monitor the informal sector, however, the economic activity that a more standardised informal sector will encourage will offset these costs in the long term. For instance, after amassing a sizable informal sector in 2007, China enacted the 'Labour Contracts Act' which enforced basic labour standards in the informal sector which has contributed greatly to the reduction of informality since (Durham University, 2018).

- **Social Protection-** The implementation of social insurance for informal workers not only significantly supports SDG No.8 Decent Work, but also structures the sector in a way that avoids economic shocks that may halt productivity (Sabatini, 2021). The COVID-19 pandemic revealed the detrimental effects of this absence of social protection in the informal economy, as 60% of informal workers' incomes significantly decreased as a result (Swarna et al., 2022) and many were left unable to cope in the pandemic without basic protections like health insurance. The implementation of even partial unemployment and health insurance can significantly benefit the millions of people in the informal sector, as well as the implementation of pension programs that provide a greater social security net.
- **Fiscal Policy-** The use of fiscal policy can greatly impact the informal economy. A decrease of taxation related to small businesses affords small firms within the informal sector the ability to formalise more easily, and also provides incentives for more firms to operate formally. This policy may be perceived as decreasing the country's revenue through a loss of taxation, but conversely, the economic development provided by increased formalisation will offset this loss significantly (Bandaogo, 2016).
- **Access to Finance-** Most informal workers are unable to access finance (such as business loans) as a result of their low-income background. Greater access to financial services in the informal sector will allow for the development of informal businesses which allows them to gradually formalise. In fact, research has shown that there is a positive relationship between greater financial access in low-income countries and economic growth (Tilburg University, 2017). However, this policy may incur greater costs for banks that may raise borrowing costs, as increased monitoring of the informal sector will be needed to facilitate this policy (Capasso, Monferrà, and Sampagnaro 2015).
- **Regulatory controls-** A simple approach to increase the formalisation of businesses is to reduce the regulations and administrative procedures that surround formal business arrangements. Creating pathways for formalisation that are easily accessible and affordable is a key component. For instance, in St. Vincent and the Grenadines the government introduced a structural reform of the agricultural sector as high levels of informality were recognised (Caribbean Agricultural Research and Development Institute, 2019). Through this reform Farmer Identification Cards were introduced that allowed farmers to receive benefits from registration, such as fee exemptions on import duties and consumption taxes (SVG Customs and Excise Department, 2005). This policy greatly supported the formalisation of many businesses within the country and developed the agricultural sector significantly.

Policy Recommendations



- ❖ Labour Market Reforms should be implemented to encourage the employment of more formal workers. This should be accompanied by measures to increase the monitoring of the formal sector, which would increase the policy's effectiveness.
- ❖ Labour Laws should be established and enforced by governments in developing countries to protect informal workers and support decent work.
- ❖ Social protection should be developed within the informal sector to protect informal workers from shocks that may impact the economy significantly. This level of insurance will greatly benefit both economic and social development.
- ❖ Appropriate fiscal policies should be implemented on a country-specific basis that incentivise formal business operations, which supports a shift from informality to formality.
- ❖ Access to financial services must be developed for informal workers to enable the development of informal businesses which can lead to formalisation.
- ❖ Appropriate regulatory controls should be put in place that reduce the barriers to formalisation, making it approachable and accessible for informal firms.

Conclusion



The informal sector poses a unique opportunity to support sustainable development in developing countries. Through the implementation of country-specific policies that effectively manage and support the sector, greater economic and social development can be fostered. The use of a promotive policy as outlined in this brief, allows for a non-traditional approach to be used to support the sustainable development agenda and protect and support the livelihoods of millions of vulnerable people globally.

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