



ZONAL JOURNAL OF RESEARCHER'S INVENTORY

VOLUME: 03 ISSUE: 12 (2023)

P-ISSN: 3105-546X

E-ISSN: 3105-5478

<https://zjri.online>

THE INFORMAL SECTOR IN DEVELOPING ECONOMIES

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Abstract:

This article explores the characteristics, significance, and challenges of the informal sector in developing economies. The informal sector, encompassing unregistered and unregulated economic activities, plays a crucial role in employment and income generation but is often associated with low productivity, poor working conditions, and limited social protection. The article reviews theoretical frameworks explaining informality, evaluates its impact on economic growth and poverty alleviation, and discusses policy approaches for formalization and support. Understanding the informal sector's dynamics is essential for designing inclusive development strategies.

Keywords: *Informal sector, developing economies, employment, economic growth, poverty alleviation, formalization, labor markets.*

INTRODUCTION

The informal sector constitutes a substantial share of economic activity and employment in many developing countries. Defined broadly as economic activities that operate outside government regulation and taxation, the sector includes self-employed workers, small unregistered enterprises, and casual labor. Despite its significance in providing livelihoods, informality is often linked to vulnerabilities such as lack of job security, limited access to credit, and exclusion from social protection systems. This article examines the economic role of the informal sector, its determinants, and policy challenges.

1. Defining the Informal Sector

Characteristics and Scope

The **informal sector** refers to economic activities that are not regulated or protected by the state. It generally includes small-scale, self-employed, or unregistered enterprises and workers who operate outside formal legal and institutional frameworks.

Key characteristics of the informal sector:

Unregistered and unregulated: Businesses or workers are not formally registered with government authorities and thus do not comply with legal requirements such as taxation, social security, labor laws, or licensing.

Small scale: Often consists of microenterprises or individual self-employed workers with limited capital and resources.

Labor intensive: Typically involves manual or low-skill labor with minimal use of machinery or technology.

Lack of job security and benefits: Workers in the informal sector usually do not have formal contracts, social security benefits, or labor protections.

Low productivity and income: Informal activities tend to generate lower earnings and productivity compared to the formal sector.

Flexibility and survival strategy: The informal sector often serves as a means of livelihood for vulnerable populations who cannot access formal employment.

Diverse activities: Includes street vending, domestic work, small-scale agriculture, informal manufacturing, home-based work, casual labor, and more.

Scope:

The informal sector can vary widely across countries and regions. It is particularly significant in developing countries where formal employment opportunities are limited.

It can represent a large share of total employment, especially in urban areas and among marginalized groups like women, youth, and migrants.

The informal sector contributes substantially to the economy by providing goods, services, and employment, though often overlooked in official economic statistics.

Measurement Challenges and Data Limitations

Measuring the informal sector accurately is challenging due to several factors:

Lack of registration and documentation: Informal enterprises and workers are not registered with government agencies, making it difficult to track or count them through official records.

Heterogeneity: The informal sector includes a wide variety of activities with varying degrees of informality, making it hard to define clear boundaries.

Underground activities: Some informal activities may be hidden deliberately due to tax evasion or fear of legal consequences.

Data collection difficulties: Informal workers may be hard to reach due to their mobility, lack of fixed workplaces, or distrust of officials.

Underreporting and misclassification: Surveys may miss informal workers or misclassify them as unemployed or in the formal sector due to ambiguous definitions.

Differences in definitions: Countries and organizations use varying criteria to define the informal sector, affecting comparability.

Dynamic nature: Informal activities can be seasonal, part-time, or temporary, making snapshot measurements less reliable.

Common data sources and their limitations:

Labor force surveys: May capture informal employment but depend on questionnaire design and respondent accuracy.

Enterprise surveys: Often focus on formal registered firms, excluding many informal operators.

Censuses: Provide comprehensive data but may not capture informal work in detail.

Qualitative studies: Provide rich insights but lack representativeness.

2.2 Theoretical Perspectives

Dual Economy Models (Lewis, Harris-Todaro)

Lewis Model (1954):

Arthur Lewis proposed a two-sector model where the economy consists of a traditional, subsistence rural sector (informal sector) and a modern, capitalist urban sector (formal sector).

The **informal sector** absorbs surplus labor from the rural sector without reducing rural output.

Labor migrates from rural (informal) to urban (formal) sector seeking higher wages.

Urban formal sector initially benefits from unlimited labor supply at subsistence wages, but eventually wages rise as surplus labor depletes.

This model views the informal sector primarily as a reservoir of surplus labor that supports industrial growth.

Harris-Todaro Model (1970):

This model focuses on rural-urban migration driven by expected income differences, considering the risk of urban unemployment.

Migrants weigh the probability of finding a formal job against rural income.

Many workers end up in informal urban jobs when they fail to secure formal employment.

Informal sector is seen as a buffer absorbing urban labor market excess, often resulting in urban informal unemployment or underemployment.

Informality as a Survival Strategy

Informality is often **not a choice but a necessity** for many individuals and households facing limited formal employment opportunities.

People engage in informal work to:

Secure a source of income in the absence of formal jobs.

Avoid regulatory burdens like taxes, fees, or complex compliance costs that are prohibitive for small-scale operators.

Maintain flexibility in working hours and locations to balance other household responsibilities.

This perspective highlights the **social and economic vulnerability** of informal workers and the informal sector's role in **livelihood sustenance** rather than economic inefficiency.

Institutional and Regulatory Frameworks

The informal sector exists partly because of the **institutional and regulatory environment** in a country.

Strict labor laws, high taxation, complex registration processes, and rigid regulations can **push small businesses and workers into informality** to evade costs and bureaucracy.

Conversely, weak enforcement of regulations and lack of social protection mechanisms may also allow informal activities to flourish.

This perspective emphasizes:

The role of **institutions** (laws, policies, governance quality) in shaping the size and nature of informality.

The potential for **regulatory reforms** to incentivize formalization, such as simplifying registration, reducing compliance costs, or extending social protections.

It recognizes the informal sector as a response to institutional constraints rather than simply a problem of the economy.

2.3 Economic Significance

Contribution to Employment and Income

The informal sector is a **major source of employment**, especially in developing and emerging economies.

It often provides jobs to groups with limited access to formal employment, such as women, youth, migrants, and low-skilled workers.

Estimates suggest that in some countries, the informal sector can account for **up to 60–70% of total employment**.

Informal work generates vital income for millions of households, often serving as the **main or supplementary livelihood**.

Despite lower wages and lack of social protection, informal employment remains a key means for survival and economic participation.

Relationship with Poverty Reduction

The informal sector plays a **critical role in poverty alleviation** by offering income opportunities to those excluded from the formal labor market.

Informal activities help **smooth income fluctuations** and provide a buffer during economic shocks, crises, or unemployment.

However, jobs in the informal sector tend to be low-paid, insecure, and vulnerable to exploitation, which may **trap workers in chronic poverty**.

Access to the informal sector alone is often **insufficient for long-term poverty reduction** without improvements in working conditions and opportunities for upgrading.

Productivity and Growth Implications

Informal sector productivity is generally **lower than the formal sector** due to limited access to capital, technology, skills, and infrastructure.

The informal sector's predominance can have mixed effects on economic growth:

On one hand, it **absorbs surplus labor** and contributes to economic activity that would otherwise be lost.

On the other hand, large informal sectors can **limit productivity growth and tax revenues**, reducing government capacity for public investment.

Formalizing informal businesses can boost productivity by improving access to finance, markets, and technology.

Policies promoting formalization and skill development can enable the informal sector to contribute more effectively to sustainable economic growth.

2.4 Challenges and Vulnerabilities

Labor Rights and Social Protection Gaps

Workers in the informal sector **generally lack formal labor contracts**, which means they are often excluded from legal protections such as minimum wage laws, working hours regulations, occupational safety standards, and the right to organize or unionize.

Informal workers typically do **not have access to social protection schemes** like health insurance, unemployment benefits, pensions, or paid leave.

This absence of safety nets leaves informal workers highly vulnerable to income shocks, illness, accidents, and old-age poverty.

Many informal workers also face **exploitation and precarious working conditions**, including long hours, child labor, and unsafe environments.

Gender disparities are often pronounced, with women in the informal sector facing additional barriers such as wage discrimination and lack of maternity protections.

Access to Finance and Markets

Informal businesses and workers frequently face **significant barriers in accessing formal financial services**, such as bank loans, credit, insurance, and savings facilities.

Lack of formal registration, credit history, and collateral makes it difficult for informal enterprises to obtain affordable financing.

This restricts their ability to **invest in productivity improvements, expand operations, or cope with financial shocks**.

Informal operators also often lack access to larger, more lucrative markets due to:

Limited networks and information

Exclusion from formal supply chains

Inability to meet regulatory or quality standards required by formal markets

These constraints perpetuate a cycle of informality, low income, and limited growth prospects.

2.5 Policy Approaches

Formalization Incentives and Barriers

Incentives for formalization include:

Simplifying business registration and licensing procedures to reduce costs and bureaucracy.

Offering tax incentives or phased tax schemes to encourage informal businesses to register.

Providing access to formal financial services, markets, and government support programs contingent on formalization.

Improving legal frameworks to protect small enterprises and informal workers.

Barriers to formalization often involve:

High costs and complex requirements for registration, taxation, and compliance.

Fear of losing flexibility and incurring additional costs (taxes, social contributions).

Distrust of government authorities and perceived risk of harassment or penalties.

Limited awareness or knowledge about formalization benefits and procedures.

Microfinance and Entrepreneurship Support

Microfinance institutions and programs aim to improve informal entrepreneurs' **access to credit, savings, and insurance**.

These services enable small-scale informal operators to invest in their businesses, improve productivity, and manage risks.

Complementary support often includes:

Business training and capacity building.

Market access facilitation and networking opportunities.

Technical assistance in product development and quality improvement.

Entrepreneurship support helps informal workers **transition towards more sustainable and formal business models**.

Social Protection and Labor Regulation Reforms

Expanding **social protection coverage** to informal workers is crucial for reducing vulnerabilities. Policies include:

Designing contributory and non-contributory schemes adaptable to informal employment patterns.

Providing health insurance, maternity benefits, unemployment assistance, and pensions accessible to informal workers.

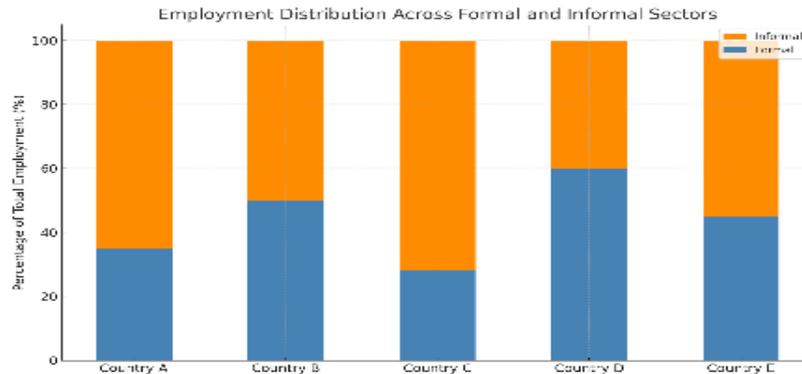
Labor regulations can be reformed to:

Extend basic labor rights to informal workers without imposing excessive burdens on small businesses.

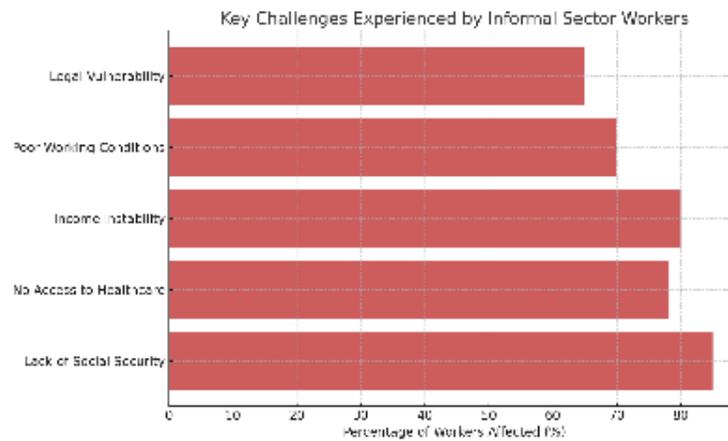
Encourage fair working conditions, safe workplaces, and rights to organize.

Promote flexible regulation that balances protection with the realities of informal work.

Such reforms aim to **improve working conditions and social security**, making informal work less precarious.



Title: Employment Distribution Across Formal and Informal Sectors



Title: Key Challenges Experienced by Informal Sector Workers

Summary

The informal sector plays a vital role in sustaining millions of livelihoods in developing economies but remains marked by low productivity, precarious employment, and limited social protections. Theoretical models suggest informality arises from structural economic factors, regulatory constraints, and survival needs. While informality contributes significantly to employment and poverty alleviation, it also poses challenges for economic growth and social equity. Effective policies balance facilitating formalization with supporting informal workers' rights and capabilities, leveraging financial inclusion and regulatory reforms to foster inclusive development.

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