

# 1 Introduction

## THE INFORMAL ECONOMY

The informal economy has emerged as one of the most dynamic, active, and hotly debated domains in the developing world. Unfortunately, at the same time, it also remains one of the least treated subjects in mainstream economic theory and development economics. No text on international trade or development economics offers a separate chapter on informal activities in spite of the fact that much of the workforce in poor countries is absorbed in this segment. In India, the informal sector provides livelihood to more than 90 per cent of the workforce.

If Arthur Lewis (1954) had rewritten a more contemporary version of his classic article on growth with unlimited supplies of labour, he would have definitely brought this phenomenon to the core of the development analysis. It should be noted that Harris and Todaro (1970) failed to recognize the fact that open unemployment among the poor and relatively unskilled in anticipation of uncertain future employment in the formal sector is not a sustainable proposition. Poor workers cannot survive without jobs and as a result the real search costs for a job can be remarkably high for them. Recent employment data published by the National Sample Survey Organisation (NSSO) in India shows that poorer groups have a smaller rate of unemployment. The point is that the observed unemployment rate among the poor should

be quite low and unemployment as such is not the right indicator of their suffering. A rickshaw-puller or a porter cannot afford to remain unemployed for too long. Fields (1975), using a closer approach to Lewis' basic model, did include a third option for migrants in terms of the urban informal sector. However, the choice to remain unemployed was still an open possibility.<sup>1</sup>

Modern analyses of rural–urban migration of labour accommodate both open unemployment and informal employment in Harris-Todaro type models. This ensures that the informal wage does not fall below the rural wage, and in some cases these two are equalized. Urban informal wages are held equal to rural wages owing to the perfect intersectoral mobility of labour (Marjit and Beladi 2008). Perhaps, open unemployment among the unskilled and poor is something one should abstract from. Instead, one should focus on the quality of jobs that these people have; a common indicator of their well-being will be the real wages that they earn. Thus, expansion in the size of the informal sector should not necessarily be treated as a curse. This can happen both through an expansion of demand and supply with opposite implications for equilibrium wages. For example, one may observe an increase in wages as well as employment and as a consequence an improvement in the general living standards of informal workers. We refrain from committing to a preconceived idea that a booming informal sector is necessarily bad for informal labour. In fact, growth of informal wages in India has played a pivotal role in reducing the incidence of urban poverty (Kar and Marjit 2009).

The primary purpose of this book is to analyse the deeper impact of reformatory or deregulatory policies on the welfare of informal workers by incorporating the general equilibrium effects of such policies. Various implications of a more open and liberal economic environment for the informal unskilled manufacturing sector as well as agriculture are discussed from the perspective of a labour market, which includes both the formal and informal sectors. The empirical backdrop for these models is provided through stylized facts and empirical implications are highlighted in some cases. However, our work is primarily theoretical and grounded mostly in the neo-classical general equilibrium framework.

The other purpose of this book is to provide some analyses of political economic issues, governance mechanisms, and the general policy environment that sustains or penalizes the dynamism of informal markets. We also reflect on the organizational relationship between the formal and the informal and related micro mechanisms.

At the very outset one should be clear about the definition of the informal sector. There are several definitions and terminologies in related literature. For example, International Labour Organization (ILO 1972) initially referred to these activities as belonging to the 'unorganized' sector (see also Mazumdar 1983). In more recent times, the National Commission for Enterprises in the Unorganized Sector in India (NCEUS 2007) has dealt with the definition of the informal sector in great detail and it seems consistent with the international definition recommended by the ILO, where the terms 'organized/unorganized' are used interchangeably with 'formal/informal'. Therefore, we largely follow the following definition of the unorganized sector (NCEUS 2007: 3): 'the unorganised 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.' The Commission considers all agricultural activities undertaken on agricultural holdings, either individually or in partnership, as being in the unorganized sector. In comparison, recent ILO documents (2002: 2, 2007: 4) define informal units as those '... engaged in the production of goods and services with the primary objective of generating employment and incomes to the persons involved'. Such production units share common features: 'typically operate at a low level of organisation; with little or no division between labour and capital as factors of production and on a small scale; labour relations—when they exist—are based mostly on casual employment, kinship or personal/social relations rather than contractual arrangements with formal guarantees'. Moreover, these different groups have been termed 'informal' because they share one important characteristic: they are not recognized or protected under legal and regulatory frameworks. This is not, however, the only defining feature of informality. Informal workers and entrepreneurs are characterized by a high degree of vulnerability. They are not recognized under the law and, therefore, receive little or no legal or social protection and are unable to enforce contracts or have security of property rights (ILO 2002: 2). The global definition of the informal sector is presently in concordance with the manual developed by the ILO and the Delhi Group (2007).

National Sample Survey Organisation has been collecting unit level data on these activities for more than three decades in India. Since our purpose is mainly to address theory and policy matters pertaining to the informal labour market, we consider those workers as informal who are not represented by any trade union and their wages are not

determined through the process of collective bargaining. As is well known in labour economics, the insiders in labour markets, in the form of sheltered members of unions and those employed with institutionally recognized benefits, are very different from the outsiders who are necessarily exposed to market fluctuations and cannot claim, for example, the minimum wages. The story of the informal labour market is essentially the story of these outsiders. Their wages and employment are largely market determined. More precisely, we are concerned with a dual labour market where a relatively small number of formal sector workers get the benefit of trade union protection or formalized labour regulations, such as minimum wages and retirement and health benefits. The vast majority of the workforce is absorbed in the rest of the economy, including agriculture, at low market-clearing wages. Thus, the informal labour market emerges as a large residual of the employment process. In this book we use the terms formal (informal) and organized (unorganized) interchangeably. More generally, the *organized sector* comprises of enterprises for which statistics is available regularly from budget documents or reports, annual reports in the case of the public sector and through the Annual Survey of Industries (ASI) in the case of registered manufacturing for India. On the other hand, the *unorganized sector* refers to those enterprises whose activities are not regulated under any legal provisions and/or which do not maintain any regular audited accounts. Consequently, data on such enterprises are also of limited reliability. This definition closely follows that developed by the ILO (1972). For India, the enterprises covered under ASI belong strictly to the organized sector (55th NSS Round, Report No. 456/55/2.0/1: 2).

In general, agriculture in developing countries is largely within informal arrangements. The sector usually exhibits full employment and, more often, disguised unemployment owing to large dependence on land. A huge drop in the land-man ratio may not cause open unemployment, but will devastate the per capita income of agricultural workers. It may be argued that the problem for the very poor and the unskilled has never been lack of jobs, but wage rates or the price at which poor workers are likely to find such employment. In addition, the working conditions have also remained sub-standard in industrial and other sectors. Thus, most of the models we work with are full-employment models with wage differentials. The assumption of full-employment among unskilled workers is justified on the ground that if they are observed to survive in the labour market, they must be engaged in some activity however insignificant and undesirable that might be. It should be clearly noted that studies that deal with minimum wages,

open unemployment, wage negotiations, and employment subsidies essentially cover a small percentage of the labour force in poor countries. This leaves out the majority for which wage levels and not employment status is of critical importance for measuring living conditions. On this note, we emphasize that the issue of wage determination and wage movements in the informal sector should have received more attention than they ever did.

Our approach aims to address the general reluctance in literature in pursuing general equilibrium analyses of the features embedded in the interactions between the formal and informal sectors. To the best of our knowledge, none of the prior theoretical and empirical studies on the informal sector have discussed the general equilibrium effects of inter-sectoral mobility of capital and labour. Our structure is similar to one used by Carruth and Oswald (1981). Agenor and Montiel (1996) is an exception in this regard, albeit their model is relevant for a macroeconomic structure unlike the general equilibrium approach that we adopt here. The lack of such attempts might have been caused by the fact that transitions in the informal sector are generally slow and often invisible. It is the result of constriction created by state regulations, social constraints, or risks and uncertainties. At other times, such movements may be quite rapid and in effect substantiate the theory that resources in the long run do have a tendency to move from low to high return sectors. An analytical view in this regard is usually restricted to one single industry, one production unit, or even one particular location. Analysis of general conditions based on partial evidence is at best incomplete. The case of the informal sector in India has not been an exception in this regard. In some of the chapters in this book we point out that if capital is treated as a 'black box' one may also obtain certain outcomes regarding wage-employment movements carrying mis-specification problems.

Thus, one recurrent theme that we discuss deals with how informal wages respond to unemployment among the formal or organized/unionized segment of individual industry types. It has been shown theoretically (Marjit 2003; Marjit and Kar 2004, 2008a, 2008b; Marjit et al. 2007a, 2007b, 2009)<sup>2</sup> that informal wages can move up or down depending on assumptions about capital mobility between formal and informal activities. These studies use simple general equilibrium structures to answer a critical question—how do changes in exogenous policies in the formal sector affect wages and employment conditions in the informal sector? For example, roughly between 1995 and 2003 employment in the organized manufacturing sector and wages

in the organized sector in India did not show much improvement, and neither did the capital stock. Productivity growth was also quite limited. Compared to this, data on wage-employment and productivity within the informal sector as available from NSSO for most of the states and union territories in India tell a completely different story. It has been empirically verified that labour productivity, fixed assets, per unit value added and real wages in the informal sector, all improved in comparison with the typical organized sector in India. Without capital accumulation in this sector, the observed upward wage movement or productivity growth would not have been possible. It should also be pointed out, however, that according to the 2005–6 NSSO report on unorganized manufacturing units, real informal wages fell below the high level attained in preceding years. It remains valid nevertheless that the post-reform decade in India has seen an unambiguous improvement in the real wages of informal workers in a majority of the states.

In development discourse, whatever be its ideological or rhetorical origin, 'informal' is a derogatory term. Workers in this sector are sometimes called marginalized, underprivileged, dying to be formalized, located at the receiving end of liberal policies and suffering from undesired pitfalls of free market mechanisms. We do not deny the fact that the conditions of workers in this sector can be quite deplorable and improving their conditions to any acceptable standard is the need of the hour. However, one could still highlight the point that this sector, like many others, may easily get the benefit of a more open and liberal economic environment. This point has been noted in various recent works, such as in Harris-White and Sinha (2007) in the context of India. It is important to realize that the informal sector can be far more dynamic than the organized sector provided the workers in this sector have the right opportunities to flourish. Contrary to general wisdom, the informal sector is not synonymous with an entity that necessarily stagnates in a low-level equilibrium trap. In fact, both informal manufacturing units and self-employed units accumulate fixed assets, invest and prosper, and they may do so even at a time when their formal counterparts show much less dynamism. No doubt, outcomes facing informal units are more likely to be mixed than uniform, but there are situations when markets deliver clear benefits to the workers engaged in this sector. It is, however, contingent not only on the degree of capital mobility as the pre-deployed capital needs to be reallocated from non-viable sectors to those offering higher returns, but also on institutional capabilities to reformulate existing regulations.

A number of issues that necessitate discussion at an early stage have to do with the emergence, sustenance, and characterization of the informal economy. What causes the informal sector to emerge and grow? Is it all economics or a refined political strategy? What are the focal points of analyses that relate informal labour to the broader issue of development? Is formalizing the informal the right solution? What is a good theory of enforcement of labour regulations? Besides addressing these questions, we also try to highlight some work done in the interface of economics and politics, including that on the association of informality with property rights, social welfare, and the general issue of governance.

The following chapters provide a detailed treatment of some of these issues. However, even such comprehensive coverage is far from exhaustive in view of the large number of potential issues that could not be accommodated and shall motivate both the readers and us equally to ponder over in the future. Chapter 2 discusses the political economy aspects of the survival and performance of the informal sector. This, to our understanding, is one of the core issues that demands much more involved research in order to deal with subsequent questions, theoretically, empirically, and in terms of policy propositions. Chapter 3 brings in the flavour which essentially is the germinator of all analyses on the informal sector, namely, the transition from agrarian societies to urban economies. The factors of production trapped in the middle of the process of this transition now constitute the well-known informal sector. Therefore, a legitimate space is offered towards an understanding of this mobility issue; these are re-evaluated in terms of developments either in the agricultural sector or in the advanced urban manufacturing sector. Chapter 4 deals with the case of production organization between the formal and informal sectors. Once it is realized that the political economic environment of the country or the region therein accepts the coexistence of both the sectors, the immediate question is whether production takes place in the former or in the latter. This involves an understanding of complex optimization decisions by different agents—producers, workers, and labour unions, and their interactions with the state.

Chapter 5 is devoted to a comprehensive coverage of the informal sector through the use of general equilibrium models. So far many studies have used general equilibrium structures to understand wage and employment behaviour in the informal sector. We offer a review of the important results and develop a model with capital mobility between the formal and informal sectors to improve upon the present state of analyses. The welfare implications of such wage movements in the

informal sector come as a natural follow-up and this is what Chapter 6 discusses in detail. Further, that goods produced within informal regimes may be traded directly or indirectly generates an additional characteristic. Chapter 6 deals with trade in informal commodities and measures the welfare levels under various exogenous shocks. As extensions of the basic model, we relax assumptions on full-employment of labour and allow unemployment to re-evaluate conditions that improve the general welfare of the economy. This chapter also incorporates possibilities that many of the informal commodities and services are of the non-traded variety. This leads to a more comprehensive coverage of the issue of welfare in the informal sectors. Chapter 7 discusses the role of unionization in the economy when a sizeable informal segment exists in the country. The models in this chapter are developed from the extended Heckscher-Ohlin framework, which offers enormous scope to manoeuvre within various combinations of formal–informal interactions. Therefore, Chapters 2 to 7 are designed to accommodate various theoretical contributions on the functioning of the informal sector; these chapters are categorized as Part I of this volume.

Part II is shorter and deals mainly with aggregate empirical evidence for India as well as smaller case studies from different locations to buttress our main findings. Chapter 8, the first chapter in Part II, provides an explanation on how informal real wages increased across most states in India over a period of two decades. We contemplate a number of explanatory variables as responsible for such increase in real wages and figure that capital mobility between the formal and informal sectors may be deemed as one of the most influential sources. However, throughout this part we keep lamenting about the paucity of data that could lend empirical support to our results. In fact, the empirical evidence is not an exact test of the theory developed in Part I. A proxy variable capturing inter-sectoral capital mobility serves to drive some empirical findings in concurrence with our theoretical predictions. However, the subsequent statistical findings are based on data from primary surveys and the issue of production organization between the formal and informal sectors offers a rich basis for further theoretical and empirical investigations on the subject. The aggregate study on informal wages, nonetheless, seems quite powerful in explaining the role it plays in poverty alleviation among a large number of workers engaged in the sector (Chapter 9). In fact, we found that a 1 per cent rise in real informal wages, as influenced by factors discussed in Chapter 8, lowers poverty by 0.229 per cent, or roughly a 23 per cent reduction against doubling of informal wages. This chapter proposes



that exogenous shocks might lead to reallocation of resources within the informal sector and that more industry dominance shall replace the menial work that informal labour is often forced to undertake as a sheer survival strategy. The proposition reflects the mobility of resources within informal activities and enriches the scope of empirical investigations in the future. This is followed by an estimate of the productivity effect of informal workers on their wages, and to this end we use the Data Envelope Method (DEM) to disentangle the growth in efficiency as a component of total factor productivity. Chapter 10 offers these results. Chapter 11 discusses two independent case studies from Dharavi in Mumbai and Surat in Gujarat. Dharavi's reputation was partly linked to the production of leather goods that were regularly exported to rest of the world. The boom in real estate and its implications for land prices seems to have outcompeted an otherwise successful informal activity in Dharavi. Once again, these are issues where a lot more attention is needed and, more importantly, these features can raise new and interesting questions in economics. The paper industry in Surat, on the other hand, is a turnaround from formal large company structures to smaller informal firms which find it easier to compete with the growing participation of countries like China and Indonesia in similar trades. Therefore, in terms of theory and statistical evidence culminating into policy propositions, these case studies can be veritable sources of information.

Finally, Chapter 12 summarizes the results of the volume and discusses relevant issues and areas for further research. Since we deal with elements of economic reforms as important instruments for the series of results in this book, a short introduction on the nature of reforms implemented in India is now discussed. Although the specific nature and scope of these elements would differ across major developing economies around the world, the direction of reforms has been quite similar everywhere, especially since the introduction of the World Trade Organization (WTO) and the drive towards multilateralism. This section puts the link between economic reforms and informality in a context that we explore throughout the book.

#### **ELEMENTS OF ECONOMIC REFORMS IN INDIA**

The process of economic reforms undertaken in the Indian economy in the early 1990s paved the ground for a unilateral restructuring of trade policies with significant departures from the policy focus of the preceding decades. At the point of formal initiation of the restructuring