

Causes of Option for Informal Sector

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Abstract

Informality is a feature, specific to any economy, regardless its nature and development degree, but it has a significant share in developing or poorly developed economies.

In this paper we aim to present the causes determine individuals to opt for informality, whether we are talking about the workforce, or we are talking about entrepreneurs or small companies. Therefore, in this paper we will identify what kind of causes determine the labor force (the employees) to opt for informal employment or employment in the informal sector and also what causes determine the entrepreneurs and firms to opt for the informal sector of the economy.

We will also try to establish whether the choice for the informal sector of the economy is a rational decision or is an irrational behavior of individuals.

Keywords: informal sector, informal employment, dual economy, employment in the informal sector

JEL classification: E26, J46, J48, J24

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1. Introduction

Informality casuistry can be viewed from several perspectives. Obviously, there are many approaches of the informality causes, depending on the school of thought to which we refer. There are three important approaches of the informality emergence as determinants facts.

A first approach of the informality causes is found in Dinga's studies (2009), which classifies the causes that determine the emergence of the dual economy in: general causes and sectoral causes. Another approach of the informality causes is found, according to the state policies, in the Perry, Maloney and col (2007) studies, and a third approach of the work informality casuistry can be made according to the development degree of the country and belongs to some authors, such as Tanzi (1982) or Gerxhani (2004).

Dinga (2009) classifies the general causes underlying the emergence of informality as follows: formal causes (determined by ambiguous or incomplete legislation), structural causes (determined by bureaucracy and corruption), managerial causes (determined by the ineffectiveness of the fiscal administration

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exercised by the government) and conjunctural causes (determined by globalization).

Regarding the sectoral causes, Dinga (2009) classifies them according to the type of the resulting economy, as follows:

- Regarding the illegal dual economy, this is generated by the following causes: the imperfect structure of the market (by cartel, union or monopoly); the inability of the government to observe such activities, including the inability of the banking system and the Central Bank to identify and monitor money laundering circuits; the possibility of carrying out illegal activities through international channels, being strongly influenced by the phenomenon of globalization.

- As regards the generation of the unregistered dual legal economy, this is generated by the following causes: legislative incompleteness; an inefficient state control system; fiscal pressure; the exaggerated cost of legalization.

- As regards the generation of the registered dual legal economy, it is generated by the following causes: volatility of monetary macroeconomic variables, in particular inflation and exchange rate; implicit taxes and fees; legislative volatility.

Another cause of informality is the state policies regarding the labor market. These are important factors in the decision of individuals or companies to opt for the informal sector. These include: excessive labor costs; the costs with the contributions of social protection and health insurance; the number of limited places in the formal sector; the difficulties for women (especially those married and with children) to cope with work and household obligations (Perry, Maloney et al, 2007).

A third approach of work informality causality refers to the degree development of an economy. Depending on the degree development of an economy, the reasons and causes of informalization differ in developing countries from those in transition or developed countries, as follows (Tanzi, 1982; Gerxhani, 2004):

- In developing countries: low rate of industrialization and productivity; labor surplus; process of globalization; stagnation and the economic crisis.

- In transition countries (former socialist countries): presence of common socialist property; price control, centralized allocation and rationalization of goods; the prohibition of a wide range of articles and services; low degree of economic freedom; inefficiency of the support and social protection system; trade liberalization; privatization process; process of globalization.

- In developed countries: process of globalization; recession, with its consequences: unemployment, loss of capital, etc; over-regulation of the formal sector by the government; how fair the tax law seems to taxpayers; the attitude of the taxpayers towards the government; their cultural traditions; penalties applied to trapped evasionists; easing with payment of taxes can be eluded; taxpayers earnings through non-payment of taxes.

All these "obstacles" also show us a lack of flexibility of the formal sector, and have a negative effect on the increase of labor productivity, this being the most

important factor that would make a good part of the informal system become formal.

From another perspective, it can be analyzed causes that determine the size of the informal workforce, as a share of the total labor force in an economy. Mainly, they are: the poor quality of the institutions; distrust of the state; mistrust of laws and their correct application; inequalities caused by different regulations (tax privileges, legislative lack); cumbersome regulations; exaggerated bureaucracy; high degree of corruption; monopoly abuse (small producers cannot compete with or have access to large chain stores); wrong macroeconomic policies, followed by restructurings that increase the number of unemployed, who most often do not find a job in the formal sector; poorly designed social protection systems; regional specificity and tradition (Perry, Maloney et al, 2007).

Another category of reasons opting for the informal sector refers to the fact that the informal sector is attractive or represents an alternative to formal work, sometimes even the only solution. These cases refer to (Perry, Maloney et al, 2007):

- Financial benefits. These are taken into account when the incomes that can be obtained in the informal sector are higher than those in the formal sector, to compensate for the lost value of the benefits provided by social insurance;
- Non-financial benefits. Even if informal incomes are lower, they are offset by non-pecuniary benefits, such as: greater independence, autonomy and flexibility of the workplace;
- Non-financial benefits of some social categories such as married women with children, who prefer a job with a certain independence, with greater flexibility, to cope the domestic obligations.

The fact that informal work is the only alternative to formal work for certain social categories: the unemployed; young people looking for a job (especially the unskilled ones, who need to develop certain skills or qualifications in the workplace before they can enter the formal sector, from this point of view the informal sector of the economy representing a high school better apprenticeship than formal apprenticeship); old people who, even if they have the opportunity to work in the formal sector, do not want this, because the accumulated years of work would be insufficient to receive a pension.

2. Option for informal sector

The companies choice to activate in the informal sector is mainly related to: fiscal policy, excessive bureaucracy, the need to reduce costs, productivity, as well as internal competition, but especially to the one existing on international markets.

Most studies on the choice of firms for informality have concluded that most small companies do a cost-benefit analysis, balancing, on the one hand, the benefits of informality (they do not pay taxes and fees, avoid heavy bureaucracy and government controls), and on the other hand, the costs of informality (the risk

of being sanctioned, the "bribe" to be given to civil servants, the heavy access to the markets, the lack of access to public services) (Frey, 1989).

Apart from the companies operating in the informal sector of the economy, there is a category of companies that, although registered and part of the formal sector of the economy, they also carry out informal activities in sense they declare incomes lower than in reality, to pay less taxes or resort to informal work, to pay lower wages and not to pay social contributions.

The pecuniary advantages of informality allow companies to reduce their wage costs, thus being able to make price reductions and thus better adapt to the growing competition in domestic and global markets (Ruffer et al., 2007; Goldberg et al., 2003; Perry, Maloney et al, 2007).

Among the reasons why companies would like to give up informality and become formal are the following (Perry, Maloney et al., 2007): avoiding the sanctions, that these firms are liable for if they are discovered by state authorities; voluntary compliance of civic or moral spirit; avoiding the "bribe" that these companies have to pay to the control bodies if they are identified; if they want to expand and gain a larger segment of the market, by gaining new customers; to gain access to credit or financing from banking companies; to conclude contracts.

3. Option for informal employment

There are two types of informal workers: (Henley, 2006; Ruffer et al., 2007; Perry, Maloney et al., 2007)

- Workers who were excluded from the formal sector, by losing their jobs. In most cases, we will find them in the informal sector, as employees, either in informal microfirms or in formal firms that partially use "black work". Until recently this was the only point of view regarding the causes of informal entry: exclusion.

- Newer studies have shown that besides the components of exclusion, there is also an important component of voluntary exits from formal and entry in informal. In most cases, these are workers who choose to carry out informal activities independently, where, in addition to earnings that are at least equal to those in the formal, they also have the advantage of autonomy and flexibility of work.

Some studies show that most self-employed workers (about two-thirds) choose to "voluntarily" leave the formal work, preferring the freedom of informal activity on their own and giving up the state social insurance system offered by the formal sector of the labor market. Most self-employed people prefer informality because the formal gains they can get are at least as small. Thus, they are not excluded from the formal sector, but voluntarily opt for the informal sector following a cost/benefit analysis. The opposite is represented by informal employees who are "excluded" from the formal area of work, in particular because of the social contributions that formal work implies, in most cases these are difficult to bear by employees but also by some employers, who prefers to hire

workers in an informal manner. Most of the time, they are excluded from the formal sector of the economy by the decision of the employer who prefers to circumvent the payment of social contributions for these workers, even at the risk of being identified by the state tax authorities (Perry, Maloney et al., 2007).

Summarizing the above, we can say that: some people would like work in the formal sector, but not find a job, while others, even if they could, do not want or no longer want to work in the formal sector.

A number of authors, based on their research, identified the main reasons why workers prefer the informal system (Maloney, 2004; Fields, 2008; Perry, Maloney et al, 2007): wage benefits or non-wage benefits; job flexibility (especially women want to have a balance between time spent at work and home responsibilities); autonomy, they want to be their own employer; stability; mobility; pecuniary benefits (the money paid on social insurance in the formal sector invests them in their own business, especially if a family member is insured); lack of confidence (they do not trust that in old age the state will be able to pay their pension).

Moreover, because even large companies (from the formal sector) practice significant tax evasion and partial work informality ("black" work with some employees, without paying social insurance contributions), this is one reason in addition, so that informal workers are not tempted to become formal.

The option for informality is analyzed, in more detail, by different authors from other perspectives, such as:

- From perspective of social protection. Social protection is rather considered rigid because the social protection system in the formal sector does not take into account the needs and priorities of workers at different stages of the life cycle. For example, young people have other priorities than mature or old people, like: education, housing, etc. Some workers prefer to use otherwise the money they would spend on taxes, pensions, social security and this because their needs are different, with reference to the present and less to the future. They need enough income to cover their daily living needs and think less about retirement (in the uncertain future) or health insurance (for occasional events). In some states, if in one family, one member is insured, working formally, the other members (who work informally) will benefit from the insurance of the one who has it and thus have no means to insure themselves by performing a formal activity (Perry, Maloney and col, 2007).

- From perspective of specifics and traditions of each country. In underdeveloped or developing countries, surveys show that people prefer a higher wage (even if they do not have job security) or greater flexibility in the workplace (even with the risks of not receiving social protection), than a lower salary, but more secure (also having social protection benefits) (Perry, Maloney et al, 2007). In contrast to developed countries, the results of social surveys in Romania have shown that people's preferences are different, namely a safe and socially protected work place, even worse paid, than a well-paid and insecure one.

- From the point of view of non-pecuniary benefits. The formal system is characterized by a high dose of inflexibility. But, there are some people, especially women, and especially those married and with children, who have to deal with both the demands of the workplace, as well as the household and childcare tasks. For this reason, working time flexibility is an important asset for informal work, even when earnings are not as large as formal ones (Ruffer et al., 2007; Fields, 2008; Goldberg et al., 2003).

We can conclude that, based on the situation and conditions existing on the labor market, at one point, in each country, the workers, after performing a cost-benefit analysis, voluntarily decide whether to work on their own or as employees and if their activity is in the formal sector or in the informal one.

4. Option for informal sector: rational decision or irrational behavior?

Starting from the way of looking at informality, respectively as a result of voluntary “exclusion” or “exit” from the labor market, depending on the factors that determine the workers to leave the formal sector of the labor market, we try to establish whether the option for informality is or not a rational decision.

How do we define rational behavior in the economy?

Both neoclassical theories, namely the monetarist and the Keynesian ones, have emphasized the hypothesis that the natural state of a market economy is that of being in balance and that the participants in the economic life always act rationally, pursuing their own goals.

An assertion regarding the purpose of the individual is made by J.S. Mill who tells us that “a distinction is often made between the ideal that an individual should have the right to pursue his own goals and the consequence that, left free, he will pursue only his own selfish goals” (Mill, 1946).

Continuing Mill, Hayek tells us that “to do for the good of others your main purpose is a part of human nature and one of the essential conditions of happiness. However, general altruism is a meaningless conception. No one can really care about others as such; the responsibilities that we can always assume must be customized, they can only refer to people about whom we know specific things and to which we have linked either by choice or by special conditions” (Hayek, 1960).

The individual's behavior is considered "rational" when he "chooses more instead of less and shows consistency in the choices he makes. When it is made to choose between two packets of goods, one of them containing a larger quantity of one good and a smaller one of the other, compared to the other package, the hypothesis of decreasing marginal substitution is introduced; (...) Consumers will choose packages of goods containing larger quantities of everything, all other conditions being equal” (Buchanan, Tullock, 2010).

How do we define irrational behavior in the economy?

In any capitalist economy, there are three categories of participants in economic life, both through rational behavior, as defined above, and through irrational decisions, related to the psychological characteristics of decision-makers, such as preferences, feelings or their emotions. These constraints of an endogenous nature, together with those of an exogenous nature, related to the access to information and the costs of processing the information limit the possibilities of rational action of the participants in the economic life. The three categories of participants in the economic markets are: the consumer, the trader and the state, in double quality, both as a public service provider and consumer, as well as a market regulator, respectively the one who sets the rules, after which the economic markets will work (Marinescu, 2012).

As we know, most economies in the world, but especially those in emerging countries, are characterized by formal / informal duality. In order to define the two sectors of the economy we can mention Hart's statement, which, referring to the dual character of the economy, considers that "certain activities and companies are formal in the sense that they are carried out in a legal framework and are subject to special regulations. , while others are behind the effective state regulations "(Hart, 2001). In the informal area of the economy, both traders can work, employing labor without legal forms or conducting commercial activities "behind the effective state regulations" as mentioned by Hart, but also individuals, who can enter the informal labor market.

The reasons why individuals opt for the informal sector of the economy are identified by some authors (Dinga, 2009) under the aspect of rational economic behavior, based on the opportunity cost, as follows:

- The advantages of an individual for initiation of an informal economic activity or for the escape from the formal economy can be: the additional gross profit obtained in the informal economy as well as the taxes and fees eluded;
- The costs that an individual supported when opting for the informal sector can be: the cost of deconspiration or identification, which refers to the sanctions that an economic agent can receive when his informal economic activity is discovered by the authorized bodies of the state and the cost of coverage, which refers to those costs related to the fact that the informal economy must remain hidden.

In case of exclusion from the market, we cannot speak of a voluntary choice, because the causes of informality are independent of the will of the workers. Rather, they relate to the employer and his or her choice for the formal or informal sector, or even the structural problems of the labor market that make the informal sector a last resort for workers. We can talk about the option for the informal sector if the informality appears as a result of the "exit" from the market, in this case the workers, most of the time, do a cost-benefit analysis, and as a result of this economically based analysis , choose to leave the formal sector of the economy opting for informal employment.

5. Conclusion

The causes of emergence and development of informality have common explanations for all countries, but also specific features, related to: the degree of development of the country, traditions and local specificity, economic policies, but can also be analyzed according to other aspects, namely from the point of view of view of the social protection, of the non-pecuniary benefits or depending on the type of the resulting economy, respectively the illegal dual economy, registered legal doubles, unregistered legal doubles.

To summarize, the causes of option for informal sector can be the following: the withholding of tax payments; circumventing the regulations related to registration and the related costs - in the case of companies; avoiding unemployment; more flexibility - for employees.

Although some authors consider that reasons why individuals opt for informal sector of the economy are related to rational economic behavior, based on opportunity cost, my opinion is that in some cases the choice for the informal sector of the economy is based on rational behavior, and in other cases it may be considered an irrational decision.

Regardless of how we interpret individuals' choice for informality, respectively rational decision or irrational behavior, the informal sector of economy remains an area outside of economic science, and the role of governments should be, not so much the elaboration of measures for eradication of informal sector, which is impossible to achieve, but design of public policies regarding the protection of workers in informal sector of economy, the latter having primary role of taking over shocks from formal economy.

Also, when designing policies for protection of workers and entrepreneurs working in informal sector of the economy, especially when labor market is characterized by high informality that has as its main cause an inadequate labor law, the key to reducing informality it must be a reform of labor law.

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