

# The Distinction between Formal and Informal on the Labor Market

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## *Abstract*

*Any economy, regardless of its level of development, is characterized by the formal-informal duality of the labor market, but informality is more pronounced in emerging economies. The measures applied in developing economies during the transition to a market economy have left behind immeasurable social costs and deep structural imbalances, especially in the labor market.*

*Among the structural imbalances in emerging economies we can mention the dual nature of the economy, represented by the two sectors of the economy, namely formal and informal, lack of flexibility of labor and low wages, which can be considered a barrier for employment.*

*In this paper we aim to make a characterization of the dual labor market and to present what are the main differences between the two types of labor markets: formal and informal.*

*In this regard, we will consider the following aspects related to: regulation, revenues / incomes, duration of contracts, flexibility, quantification, segmentation and entering to the market.*

**Keyword:** *employment in the informal sector, dual economy, informal employment*

**JEL classification:** *E26, J46, J48, J24*

**DOI:** 10.24818/RMCI.2021.4.590

## 1. Introduction

The labor market is the economic space where labor demand and supply meet and where working conditions are established, wages are set and negotiated.

The labor supply represents the labor resources available to the company at a given time and which are delimited on the basis of criteria such as: wage, workers' abilities, as well as the availability of a person to perform a job, and the labor demand represents the totality of jobs vacancies existing at a given time in an economy being influenced both by labor productivity (as marginal productivity) submitted for the realization of a particular product and by the market value (price) of that product.

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When labor supply and demand meet in the labor market we can speak of "employment", which has a dual character in the sense that it can be "formal or" informal ". Any economy, regardless of its level of development, is characterized by the formal-informal duality of the labor market.

In the economic literature, the formal sector is also called the " good jobs sector, industrial sector, modern sector, urban sector", while the informal sector is also called the "rural or bad jobs sector, traditional and agricultural sector" (Field, 2008).

Informality is even higher as the country's development and the living standard of people are smaller, the corruption degree is higher, labor productivity is lower, law enforcement is more arbitrary and impartial and rules are more burdensome, (Perry, Maloney and Co, 2007).

Informality is more pronounced especially in economies that have undergone the process of transition to a market economy.

The literature has recorded that foreign trade liberalization reforms left unprotected domestic firms to increased external competition, leading them to look for ways to reduce production costs, especially labor costs.

A study of the Ukrainian economy shows that reducing labor costs can be achieved in one of three ways: dismissing workers, placing workers in the informal sector or establishing subcontracting relationships with smaller employment firms, which already employs the informal workforce (Lehmann and Pignatti, 2007).

In Romania, as in the rest of the communist countries, the privatizations were made in a hurry without a legislative regulatory framework in the respective fields, and this fact determined the foreign companies that entered into Romanian market to acquire monopoly positions, local competition being almost non-existent. Thus, trade liberalization has left behind major structural imbalances, including a high level of informality of the labor market (Marinescu, 2012).

A study on the Turkish labor market (Aydin, Hisarciklilar and Ilkkaracan, 2010), exploring data on the labor force of Turkish households from 1988 to 2007, shows that during the period of liberalization and market growth, the informal non-agriculture sector is becoming an increasingly stable and structural feature of the urban labor market. The gradual erosion of traditional rural agriculture compared to the modern urban industrial division has turned into a different type of segmentation of the labor market into formal and informal, with a higher share of women in informal work.

Unlike emerging economies, developed economies have seen a significant increase in non-standard employment and informal employment in recent years, with the development of online commerce and alternative transportation, such as Uber, Bolt and other similar firms that they have created a mobile platform that facilitates work that avoids formal employment contracts.

These new work relationships differ from the standard relationship between employee and employer, which, as we know, involves a fixed work schedule, a fixed wage and a long-term employment contract.

There are more and more studies that show that non - standard work relationships have increased since 2005.

For example, a study in the USA (Bracha, Burke and Khachiyani, 2015) shows that approximately 55% of americans have been engaged in informal labor in the last two years, and this numbers was an increase over the comparable figure of 40% from the end of 2013.

## 2. The distinction between formal and informal on the labor market

"Formal employment" occurs when the contract underlying the relationship between employer and employee has a formal character, complies with legal regulations, being visible by state authorities.

As regards the "informal" side of employment, it can be of two types, namely: "employment in the informal sector", characterized in terms of production units and "informal employment", characterized in terms of jobs, the latter having a hidden and invisible character, not respecting the legal norms, reason for which it cannot be monitored and quantified by the state authorities. This is also called non-standard employment.

"Employment in the informal sector" is usually "informal employment", but it can also have a formal character, when, although the employer works in the "informal sector" of the economy, the employee has legal forms of employment, pays tax and social security contributions.

In Hart's view, the distinction between the two sectors of the economy (formal/informal) refers to: size (large or small scale), productivity (large/small), visibility (measurable/ immeasurable), type of income (from salary/from self-employed activities), market conditions (monopoly/competition). Hart states that his analysis started from Weber's theory of rationality, which refers to the bureaucratic organization of a society (Hart, 1987).

Another way to model the duality of the informal sector is to highlight two geographically distinct informal sectors. Some economists have identified three sectors of employment, namely: the formal urban sector, the informal urban sector, and subsistence agriculture (Todaro, 1969; Fields, 1975).

The existence of a dual economy can be highlighted according to several criteria, namely (Dinga, 2009):

- *Institutionality*, which refers to the way in which bureaucracy covers economic activities, in this aspect, the global economy can be: *formal or informal*;
- *Legality*, which refers to the extent to which economic activities comply with legal norms, and from this point of view, the global economy can be: *legal or illegal*;
- *Transparency*, which refers to the degree to which economic activity is registered according to legal norms in order to be monitored by state institutions. In this aspect, the economy can be *registered or unregistered*;

- *Administrative compliance*, which refers to the way in which economic activity is related to the competent public courts. This can be: *fully reported or underreported*.
- *Observability*, which refers to the degree to which economic activity is informally accessible to the competent structures of the state. From this point of view, the global economy can be: *observed or unobserved*.

### **3. The distinction between formal and informal on the labor market can be analyzed in the light of the following aspects:**

#### **- Regulation**

The main difference between formal and informal employment consist in regulating.

Basically, the main difference through the informal sector differs from the formal sector is the absence of the official rules and absence of regulations (Perry, Maloney & Co., 2007; Renooy, 1990; Sandmo, 1981; Gerxhani, 2004; Fields, 2008).

Informal workers are considered to be those who earn undeclared income or those who are self-employed in unregistered activities. A wage is considered informal if the worker earning that wage is not registered in the social security system. This group also includes people who work in their own household, or are beneficiaries of employment schemes (Beccaria & Groismann, 2015).

Concerning to the dual nature of the economy, Hart considers that certain activities and companies are formal in the sense that they take place within a legal setting and are compliant to special regulations, while others "take place behind the effective regulations of the state" (Hart, 2001).

The legal represent the main difference between that two sectors (De Soto, 1972), and informality may be synonymous with tax evasion (ILO, 1972).

Informality often appears as illegality. In many countries, the informal sector can be considered a natural segment of the economy, because it is hard to draw a bar between "women selling oranges on the street and gangsters taking their protection fee" (Hart, 2006).

#### **- Income inequality**

Regarding the incomes of the workers, there are different opinions, in the literature, regarding the differentiation of wages on the two types of sectors, formal and informal.

On the one hand, there are theories state that earning in the formal sector must be higher than wages in the informal sector.

In this regard, we mention the theory promoted by Lewis, according to "wages in the subsistence sector have established a deck with earnings in the capitalist sector, but in practice, earnings in the formal sector must be higher than

wages in the subsistence sector and there is usually a 30% or even greater gap between capitalist and subsistence wages" (Lewis, 1954)

Another theory states that a high level of leaving the formal sector may cause firms to pay employees more than the "efficiency wage", to ensure that the most efficient workers will remain in the company (Perry, Maloney et al., 2007; Stiglitz and Sapiro, 1984).

On the other hand, since small and informal firms are able to monitor their employees at no cost, they do not have to pay their employees the efficiency wage because they do his job well (1984, Stiglitz & Sapiro; 1989, Esfahani and Salhi-Isfahani).

A study conducted in Latin America, more precisely in Argentina, indicates that, on average, the hourly earnings of those working in the informal sector are with 47% lower than earnings in the formal sector (Beccaria & Groismann, 2015).

On the other hand, there are theories according to which in a labor market without rigidities, informal earnings should be higher than formal ones to cover the benefits that informal workers lose as well as the risk to which they are exposed. (Perry, Maloney et al., 2007).

Another theory is that the wage gap between formal and informal employment is greater than the gap between formal employment and informal employment, suggesting that the main cause of these differences is the status of the type of employment contract, in meaning that workers with registered contracts earn more than those who work informally, no matter if the employment takes place in the formal or informal sector. This theory is confirmed by large wage differences, when comparing the incomes of formal workers with the incomes of informal workers, in a study conducted on the Argentine labor market (Beccaria & Groismann, 2015).

#### **- Period / Duration of contracts**

Another important difference between formal and informal employment is the type of employment contract, in the sense that, unlike formal employment, where, in general, contracts are concluded for an undetermined period, in the case of informal employment contracts have a cert period, relatively small, usually about an year.

In developed economies, temporary employment contracts are considered to be an exception to a unlimited employment relationship and are therefore subject to several terms, such as the the existence of a clause justifying the time of a temporary contract, or setted several provisory contracts in a definite period of time, instead of one contract for an indefinite period.

These clauses are missing from the legislation of less developed countries, so that in these economies, temporary employment contracts can be concluded repeatedly (De Gobbi, 2007).

In most developed economies, open-ended employment contracts are especially specific to the public sector, as labor law in most developed countries gives civil servants the opportunity to be employed indefinitely and also protects the careers of civil servants, and in most developed countries, the public workers benefits from a special status.

#### - **Flexibility**

Another criterion that differentiates formal employment from informal employment is flexibility, in sense that there is a higher level of flexibility in the informal labor market than in the formal (Fields, 2008; Gerxhani, 2004; Perry, Maloney & Co; 2007; Renooy, 1990).

On the one hand, flexibility refers to labor mobility, and on the other hand, flexibility refers to the education and training of employees (most workers in the informal sector are unskilled and willing to accept low wages) and also to discrimination and social exclusion based on ethnic or other criteria (women and people with disabilities) (Marinescu, 2018).

Another aspect related to flexibility is the one approached by Joshi, according to which, whether we are talking about a poor or a developed economy, the informal labor market is flexible, because the flows on the informal labor market are very high. Switching from one economic activity to another, from one job to another as well as several jobs at the same time are very common in the informal economy and are often related to seasonal work, especially in agriculture (Joshi, 1997).

Another author who has analyzed the flexibility of the labor market is Standing, which, contrary to the views of most economists, who have associated the labor market in developing economies with lack of flexibility, comes with an opposite opinion, according to which in developing countries jobs are predominantly flexible Standing (1999).

#### - **Productivity**

Another distinction between the formal and informal labor market refers to productivity, in sense that the informal labor market sector is defined by a low level of productivity (Fields, 2008; Gerxhani, 2004; Perry, Maloney & Co; 2007; Renooy, 1990).

Aspects related to productivity, we find in the studies conducted by Arthur Lewis, who approached the dualistic modeling of the economy, based on the formal / informal antithesis.

Arthur Lewis (1954) defined the existence of two distinct sectors, namely the rural sector (represented by subsistence agriculture) and the urban sector (represented by capital accumulation), where productivity is much higher than in agriculture.

According to Lewis, the urban sector allows savings and, therefore, investment, and this will lead to an increase in labor demand, which will attract informal labor from the rural sector, characterized by low productivity.

In this way, the informal labor force in the rural sector, usually engaged in agriculture, will migrate to the urban sector, thus increasing formal employment and also ensuring a higher productivity of the formal sector.

#### - **Market entry**

One of the most used features to define the informal sector of the labor market is the ease with which one can enter this sector. According to studies by Fields, the informal sector of the economy is preferred by workers only as an alternative to formal jobs, which usually require certain specializations. The active population prefers to earn some money, accepting informal, poorly paid jobs than not earning any income at all. Fields believes that anyone who wants an informal job can always have one, barriers to entry into the informal labor market being virtually non-existent, this being in fact the basic idea of free entry into the informal labor market (Fields, 2008).

According to Joshi's theory, informal work is a first step for most young people entering the labor market, especially in developing economies, where due to the lack of experience needed in most formal jobs, young people temporarily accept an informal job. Despite their heterogeneity and the variety under which they are found, informal jobs are generally extremely unstable, and this instability has as its main cause the ease of entry/exit in/from these activities as well as their short duration (Joshi, 1997).

Another theory that addresses the ease with which people can enter on the informal labor market belongs to Harris and Todaro. They developed in 1970 one of the first models that addresses the option of workers when entering on the labor market. The authors believe that any worker who wants to work in agriculture can find free pice of land, cultivate it and then earn the marginal productivity of his own labor effort invested in that activity. This type of work in subsistence farming that ensures survival can be an alternative to working in the formal sector for a short period of time (Harris, Todaro, 1970).

#### - **Aspects related to quantification**

Another difference between the two sectors of the labor market is quantification, in sense that the lack of data on the size of the informal sector distorts the estimation of macroeconomic indicators.

The lack of data on size of the informal sector, at least in terms of revenues, evasion, prices and the number of workers and of companies operating in this sector, has serious repercussions on the accuracy of the values of important parameters, such as: gross domestic product, unemployment rate and inflation rate. This means that the economic and social protection measures taken by the

government, not being in accordance with the objective reality, do not have the expected effect or even have negative effects (Schneider, 1994).

According to the approach of the International Labor Office (ILO), which achieved the "household employment survey", a person is considered to be employed if he has been in gainful employment or has earned an income in the previous week.

Informal work also distorts employment statistics. According to a study conducted in the USA (Bracha and Burke, 2016), a significant part of those who state that they are currently employed in informal work also reported that they did not perform any paid work or from which they earned an income in the previous week. This apparent discrepancy can occur either because informal work is irregular or because individuals do not consider the informal activity they carry out like a work, unless they are directly asked about these informal activities. Given a potential underreporting of informal work, the official employment rate could be lower than the actual rate, and the employment of full-time employees is most likely higher than that indicated by official employment statistics.

#### - **The duality of the informal sector**

In addition to the duality of the labor market given by the formal and informal systems, there is a duality within the informal system, determined by the voluntary and involuntary options to work here (Ruffer et al., 2007).

This duality is revealed, if we analyze informality, from two directions (Fields, 2008):

- It is worse to work in the informal sector than in the formal one, but it is better here than not having a place to work (being unemployed).

- Work in the informal economy is preferred to work in the formal sector.

Or, in other words, some informal activities are preferable to the formal sector, others not.

#### - **Informal employment or masked unemployment**

Starting from the standard definition of unemployment, according to which, a person is considered unemployed if in the last week he did not carry out any paid activity for even an hour, and taking into account the fact that in many cases those who work informally consider that fact "do not work" (according to household surveys), in the literature informal work is considered by many authors as a disguised unemployment.

According to Turnham's theory, relatively easy entry into the informal labor market explains why unemployment rates in developing countries, characterized by a high level of informality, are comparable to those in developed countries, sometimes even lower (Turnham 1971, 1993).

Field has the same opinion, considering that in poor countries, where there are no unemployment insurance systems, most poor people cannot afford to not earn any income for more than a week. For this reason, workers will immediately

accept informal jobs, as they represent an opportunity to earn an immediate income. Therefore, this explains the fact that, in developing economies, characterized by a high level of informality, unemployment is comparable to that of developed countries or even lower (Fields, 2008).

#### 4. Conclusions

In conclusion, most studies in both developed and emerging economies, on the features of formal informal labor market duality, associate informality with lack of regulation, low incomes, underdevelopment, lack of productivity, lack of social protection and with a relatively short duration of informal activity.

However, informal work has some advantages. It is much more flexible than formal employment, access to the informal labor market is much easier, as it is the gateway to entry into the labor market, especially for young people, unskilled workers and married women with children, while also being considered a masked unemployment.

From the presented can be deduced the idea that informal work can be a viable alternative for that category of workers who, due to lack of experience or due to insufficient formal jobs, cannot have access to a formal job.

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