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## The Relevance of the Concepts of Formality and Informality: A Theoretical Appraisal

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### ABSTRACT

Since its first appearance in the 1970s, the concept of informality has encompassed an increasing number of meanings and referred to highly heterogeneous phenomena and measurement methods. The concept has been explored by development microeconomics via the notions of informal contracts and been enhanced by institutional economics and analyses of formal and informal institutions, such as conducted by Douglass North. This plurality of meanings and instruments calls into question the concept's validity. The paper synthesises the critical issues within both a development economics and an institutional economics perspective. It proposes a more relevant distinction than the formal-informal one, which relies on an alternative theory of institutions. First to be examined are the conceptual problems inherent in the concepts of informality, especially the heterogeneity of the phenomena and measurement. Then the concept is analysed according to an institutionalist perspective. The dualistic framework has little heuristic value, with informal phenomena instead forming a continuum with formal ones. This continuity is observed at the individual cognitive level — within and between activities — and at the level of institutions and contracts. The criteria of the dichotomy are not rigorously defined, written contracts being an example. Criteria, such as enforcement capacity, are furthermore not discriminatory. An alternative theoretical framework is presented that relies on different distinctions, particularly between the forms, contents, and meanings of institutions.

### INTRODUCTION

The anthropologist Keith Hart, after having analysed the 'informal income opportunities and urban employment' in his famous paper on the Frafra migrants in Ghana (1973)<sup>1</sup>, later affirmed that he would not have imagined the amazing academic fate of the concept of 'informal' in development and institutional economics. Since it first appeared in the 1970s, the notion of informal economy has, however, included an increasing number of meanings and has referred to highly heterogeneous phenomena. This has been compounded by the assimilation of a set of related concepts – informal economy, informal sector, informality -, which were explored by different sub-fields of economics. For the concept of the informal sector, this included

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<sup>1</sup> Hart (1973).

macroeconomics, macro-modelling, statistics and national accounting, labour economics, development microeconomics, agricultural and household economics, and so on, and especially the seminal notions of informal contracts and arrangements, and interlinked contracts<sup>2</sup>. The concept of informality has been enhanced by institutional economics, in particular with the well-known analyses of formal and informal institutions conducted by Douglass North. This conceptual 'nexus' has also been influenced and blurred by neighbouring notions, such as shadow or hidden economies, illegal activities and even organised crime, which were examined mostly in the context of developed countries. The latter added a normative dimension to the concept of 'informal', which was already present in the word itself and its negative connotation – bringing together phenomena that are 'not' something (i.e. formal).

This nexus of concepts resorts to different methods of measurement, collecting data and building facts, e.g., the construction of national accounts, implementation of national or local surveys, qualitative case studies, and biographical interviews. Its appropriation and operational use by multilateral organisations have endowed the concept of informal sector with specific meanings that have focused on a certain type of labour market, enterprise and employment. This has been the case with the ILO, which gave Keith Hart's concept its worldwide audience (in 1972-73). The notion of informal sector was, however, simultaneously loaded with a dimension of policymaking and operational usefulness for governments and donors, e.g., for improving statistics and national accounts, devising appropriate taxation, identifying unrecorded or hidden activities, and monitoring the evolution of labour markets, wages, unemployment. Major donors, such as the Bretton Woods institutions, developed an interest in the concept afterwards, with the informal sector becoming an important issue in aid projects (e.g., donor-financed surveys) and government macroeconomic policies. The competence of policymakers, the pre-eminence of policy issues, empirical questions, and construction of data and surveys have added to the difficulties of academic analysis vis-à-vis the concept of informal economy (e.g., the 'analysis paralysis' coined by Stark<sup>3</sup>). These difficulties already stemmed from the presence of the concept in various academic disciplines and their sub-fields (economics, statistics, and sociology, among others).

This plurality of meanings, domains and instruments calls into question the validity of the use of the concept of informality in theoretical analyses and models. Criticisms are not new, with many studies the 1970s and 1980s insisting on its fuzziness<sup>4</sup>. This paper synthesises the critical issues within both a development economics and an institutional economics perspective. It proposes a more relevant distinction than the formal-informal one, which relies on an alternative theory of institutions and a distinction between the form and content of institutions.

The first section examines the conceptual problems raised by the concepts of informality and formality - especially the heterogeneity and vagueness of the phenomena, which the notion of informality refers to - and by their measurement. It also examines the ad hoc aspect of the criteria that separate formal and informal sector and activities. This conceptual looseness affects the dichotomy between the formal and the informal, which is often assimilated into and confused with other types of dualisms: e.g., state-non state, market-non market, and modern-traditional.

The second section analyses the concept of informality according to an institutionalist perspective. It shows that the dualistic framework and the division into two exclusive and complementary categories does not correspond to empirical observation, has little heuristic value, and has both over-simplified and blurred analysis. Economic phenomena that fall under the category of 'informality' instead form a continuum with formal ones. This continuity may

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<sup>2</sup> See e.g. the review by Bardhan and Udry (1999).

<sup>3</sup> Stark (1982).

<sup>4</sup> E.g., by Peattie (1987), and the special issue of *World Development* in 1978 edited by Ray Bromley, see Bromley (1978), Tokman (1978), Harris (1978).

be observed at the individual cognitive level, within and between activities, and at the level of institutions and contracts. If dichotomies or distinctions are to be established, moreover, they cannot rely on a line drawn between the informal and the formal. Criteria are indeed not rigorously defined, such as written contracts. Criteria are furthermore not discriminatory, and those that are supposed to be more prevalent in one category, such as enforcement capacity, are found in the other. An alternative theoretical perspective is presented here that relies on different distinctions, in particular between the forms, contents, and meanings of institutions.

## 1. THE CONCEPTS OF ‘FORMAL’ AND ‘INFORMAL’: INTRINSIC PROBLEMS

As one knows, the term ‘informal’ was coined by the anthropologist Keith Hart in his article on informal income opportunities and urban employment in Ghana. From the very outset, even before its 1973 publication, it was included in a joint research endeavour of the Institute of Development Studies and the ILO. The 1972 ILO report on employment and poverty in Kenya<sup>5</sup> was thus the starting point of the use and subsequent notoriety of the expression ‘informal sector’. This was followed by other ILO studies and an explosion of both theoretical analyses and surveys sponsored by international agencies over the following two decades. Divergences emerged early on between policy-oriented studies on the one hand and theoretical reflection on the other, and heated debates flourished as to the relevance of the concept<sup>6</sup>. The ‘informal sector’ progressively became a narrower object used by labour statisticians, economists and policy-oriented multilateral agencies – e.g., employment surveys, support to national accounts, standardising surveys and international comparisons. Studies of the informal economy were stable in the 1990s<sup>7</sup>. The non-observed (underground, hidden, shadow, unofficial) economy is now a routine topic within national accounting and labour economics.

### *The ‘informal’ as a set of heterogeneous phenomena and methodologies*

As Hans Singer put it, the informal sector is like a giraffe: it is difficult to describe but easy to recognise<sup>8</sup>. The concept has had a remarkable destiny in academia as well as in policymaking, but its analytical value remains questionable. The literature repeatedly highlights the vagueness and plurality of definitions of the informal economy<sup>9</sup>, as well as the difficulty in measuring phenomena that are not well defined, as shown by the wide range of terms: non-observed, irregular, unofficial, second, hidden, shadow, parallel, subterranean, informal, cash economy, black market, unmeasured, unrecorded, untaxed, non-structured, petty production, unorganised, to name just a few. There is no common understanding as to whether they refer to the same phenomena and if not, what the relationships are between them<sup>10</sup>.

*Heterogeneity.* Over time the informal sector or economy has come to refer to increasingly heterogeneous phenomena, whereas the study by Hart focused on migrant workers in Ghana and their income strategies vis-à-vis urban job markets. The informal sector is associated with the dualistic theory of labour markets where it is a residual of distortions (government regulations, unions) pushing wages above equilibrium level and hence workers into the unprotected informal sector.

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<sup>5</sup> ILO (1972); a comprehensive history of the concept within the ILO until the 15<sup>th</sup> ICLS is in Bangasser (2000).

<sup>6</sup> For a critical history, see McNeill (2004).

<sup>7</sup> See the figure on production of documents on the informal sector in Bangasser (2000, p. 17).

<sup>8</sup> Quoted in Morice et al. (1991).

<sup>9</sup> The literature is large and has even given rise to a few reviews, e.g., Schneider and Enste (2000) on the hidden economy.

<sup>10</sup> As expressed by Colledge (2000) at the OECD Non-Observed Economy Workshop, Sochi, Russian Federation, October 16-20, 2000.

As analysed by Tokman, the relationships between the formal and the informal sectors may be viewed as a duality, or a complementarity, but they are rather an ‘heterogeneous subordination’, as heterogeneity is the major feature of the latter<sup>11</sup>. The informal sector may be distinguished from the informal economy. It refers to unregulated labour-intensive activities, self-employed entrepreneurs, micro and small enterprises, activities that take place outside the norms established by the state or outside formal firms, activities that are not registered, or which include various degrees of illegality, such as escaping taxation, non-compliance with labour regulations, financial transactions outside the monitoring of the state or banks - from capital flight to petty village moneylenders -, undeclared border trade, smuggling, and bribery. Casual work, domestic labour, and flexible contracting may or may not also be considered as belonging to the ‘informal’ sector. The multiplicity of definitions and lack of clear conceptual boundaries between these various notions make it difficult to circumscribe these activities and view them as forming a ‘sector’.

*Measurement.* Measurement is obviously difficult when the object is poorly defined. Definitional problems, however, stem not only from the definitions themselves but from the level of measurement itself and the plurality of methodologies that have been devised in order to quantify informal activities. The difficulties in building rigorous methods in order to apprehend the extension of an ‘informal sector’ have long been recognised in the literature<sup>12</sup>. From a sample of seven countries, Mead and Morrisson have shown that there is little relationship between different measurements, i.e., based on size, registration, payment of taxes and conformity to labour regulations<sup>13</sup>. There is no unique statistical aggregate that corresponds to the concept of informal economy. Statistical certainty is limited to the sub-sectors that can be rigorously defined, such as the types of enterprises or employment that fulfil certain criteria of size (e.g. less than 5 employees), organisation, payment of particular taxes, and so on.

The statistical quantification of the phenomena assimilated into the concept of unobserved economy is deduced through various tools that produce large approximations: national accounts, macro-models – macroeconomic models linked to household surveys<sup>14</sup>, based on monetary flows or stocks<sup>15</sup>, or a single indicator (e.g., electricity consumption<sup>16</sup>) or various sets of explanatory variables (e.g., tax, regulation)<sup>17</sup> – and surveys. The latter include household surveys, such as labour force surveys or income-expenditure surveys, informal sector modules, and enterprise surveys<sup>18</sup>. These quantification exercises rely on several definitions (e.g., underground, informal) and methods that cannot be added up so as to provide a rigorous idea of the economic extent of the ‘informal sector’.

The plurality of measurement methods allows for large variations in estimates. Definitions may differ at the country level: e.g., one of the first large surveys of the non-agricultural informal sector in Niger (1987-88) found that 99% of the enterprises were informal. The informal sector was defined by default as all enterprises that did not pay taxes on profits. As such it is distinct from artisanal industry, because it includes trade and services (including domestic) and distinct

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<sup>11</sup> As coined by Tokman (1978); see also Tokman (1989).

<sup>12</sup> E.g., Morrisson and Mead (1996) or Gautier (2001).

<sup>13</sup> Mead and Morrisson (1996).

<sup>14</sup> E. g, the IMMPA model developed by Agenor, which has a detailed treatment of the labour market: see among others, Agenor (2003).

<sup>15</sup> Eg, demand for currency, see Bagachwa and Naho (1995) on Tanzania’s second economy, which gives an estimate of 20% of official GDP in the mid-1980s.

<sup>16</sup> See Johnson et al. (1997) for an estimation of the unofficial economy in transition countries via the electricity consumption.

<sup>17</sup> See, e. g, Loayza (1997) for an endogenous growth model applied to the estimation of the informal sector in Latin America, or on econometric models, the special issue of the Economic Journal in 1999, e.g., Giles (1999) or Bhattacharyya (1999).

<sup>18</sup> See the OECD Handbook (2002).

from the non-recorded economy, because many enterprises are registered by the administrations in charge of licenses or municipal affairs<sup>19</sup>.

The various methods – using indicators such as discrepancies (e.g., between income and expenditure statistics, or official and actual labour force), physical inputs (electricity) and macro-models - provide high, aggregated figures. According to Schneider's review (2002) the informal economy, defined as unreported income from the production of legal goods and services, represented in 2000 41% of the GNI in developing countries and 38% in transition countries (and 18% in OECD countries)<sup>20</sup>. Analogous levels were found by Schneider and Enste in previous studies (where these activities were referred to as 'shadow economy')<sup>21</sup>. In Sub-Saharan Africa this has supported analyses that characterize the private sector as a 'missing middle' between a few large formal enterprises and myriads of micro and small enterprises. Similar figures may be found in other studies: e.g., the informal economy is said to constitute 92% of the total job opportunities outside of agriculture for women in Sub-Saharan Africa and 71% for men<sup>22</sup>. The ILO estimates that informal employment represents between one-half to three-quarters of non-agricultural employment in developing countries (48% in North Africa, 51% in Latin America; 65% in Asia, 72% in Sub-Saharan Africa), but the figures are higher if informal employment in agriculture is included. The informal sector (i.e., informal enterprises) as a percentage of non-agricultural GDP is estimated by the ILO as varying from a low of 27% in Northern Africa to a high of 41% in Sub-Saharan Africa<sup>23</sup>.

### ***Definitional criteria and logical inconsistencies***

Logical inconsistency. The definitional criteria are a crucial issue. They display logical inconsistencies in terms of hierarchy and exclusiveness, as they simultaneously involve different logical levels. An obvious problem is that the informal economy and informality are defined via the criterion of a form, i.e., a negative form (being 'informal'), and a form that implicitly refers to a mode of organisation. This criterion of 'form' simultaneously coexists, however, with a series of 'substantive' criteria that refer to categories and characteristics of firms with variable and non exclusive attributes, e.g., being small firms, having certain activities such as hawking on the streets, being urban, unregistered, participating in market activities, and so on. The 15<sup>th</sup> ICLS<sup>24</sup> Resolution (1993), which is the source of the system of national accounts (SNA93) definition, defines the informal sector as 'units engaged in production' with the objective of 'generating employment and incomes'<sup>25</sup>. The features of these units are 'typically' at a low level of organisation, small scale and with little division between labour and capital, and with labour relations based on 'casual employment', 'personal and social relations', 'rather

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<sup>19</sup> See Augeraud (1991).

<sup>20</sup> Schneider (2002).

<sup>21</sup> Schneider and Enste (2000a and b).

<sup>22</sup> Becker (2004), quoting ILO (2002a).

<sup>23</sup> ILO (2002b).

<sup>24</sup> 15<sup>th</sup> International Conference of Labour Statistics.

<sup>25</sup> The summary of the definition of the 15<sup>th</sup> ICLS made by the World Bank Urban Development website highlights its 'complicated' character. *The informal sector comprises units in the household sector, as defined by the SNA93, and which are unincorporated enterprises or do not hold a complete set of accounts, including: units - registered or not - without permanent employees; units with permanent employees and which are, alternatively simultaneously unregistered units, or units which do not register their permanent employees, or units which employ, on a continuous basis, less than a given number of persons, according to the legislative codes (fiscal or social) or to the practices of survey statisticians when they design the scope and coverage of enterprises surveys.* There are two sub-categories of informal sector units: "family enterprises" comprised of independent or own-account owners, family workers, apprentices and casual workers, and with no permanent employees; and "micro-enterprises" comprised of units with less than 5 to 10 employees (or jobs), or which do not register them, or which are not registered as enterprises.

than contractual arrangements with formal guarantees'<sup>26</sup>. Here a form (a negative one) is at the same time defined as a set of features, which entails logical problems.

*Absence of necessary and sufficient characteristics.* The respective features of the informal moreover do not constitute necessary and sufficient characteristics that would unambiguously assign phenomena in either the formal or informal category. Even if the definition only based on characteristics did not entail the problems mentioned above, this lack of specific characteristics is a serious limitation for a definition. On the other hand, even if the definition of the informal were based only on the fact of not displaying 'formal' traits, logical flaws appear: the characteristics of the 'formal' are ad hoc qualifiers and not always clear: large size, complying with legal rules, being registered and organised, and so on. This therefore affects the characteristics that are supposed to be the opposite of the 'formal'.

In addition, labour statisticians of the 15th ICLS have not only recognised the difficulty of drawing a formal-informal dichotomy, but have recommended avoiding a dualist segmentation of the economy and employment in these two sectors. They instead assumed that certain activities that are excluded from the informal sector were not necessarily formal, such as domestic unpaid services or small-scale agriculture. For the ILO, the informal economy is countered to the formal economy (regular, stable employment and legally regulated enterprises) but also to the criminal economy and the 'reproductive or care' economy (as the informal economy is part of the market economy) – though the ILO recognises the difficulties in distinguishing the informal sector within the household sector<sup>27</sup>. Many studies and surveys devise their own categorisation. This shows the logical flaws that affect the definition of the 'informal'. It is indeed logically difficult to conceive of a third category outside two concepts, with one being constructed to be the opposite of the other.

*Sector, firm, employment, activity?* Another logical problem is that informal activities may be defined as a sector (manufacturing or services), which is both a motive and an outcome of macroeconomic analysis and national accounts building. 'Informal' may also refer to types of firm or of firm features, e.g., small-scale, family or self-employment-based, low productivity associated with low barriers to entry, and low skills and levels of human capital. It may also refer to employment. The ILO recognises that the enterprise-based definition of the 15<sup>th</sup> ICLS cannot apprehend processes such as the 'informalisation' of employment, and that measuring employment in the formal sector is not identical with measuring informal employment<sup>28</sup>. It may also be defined as an activity or a type of activities: employment in the informal sector plus informal employment outside of the informal sector constituting the informal economy for the ILO<sup>29</sup>. Many surveys, however, highlight the difference of theoretical perspectives between the levels of the industry or sector and that of the firm, as firms may be heterogeneous (both formal and informal). Different results may be obtained when analysing firm-level factors, e.g., problems of entry that are not visible at the industry level, where, for instance, the problems of comparative advantage may appear as more relevant<sup>30</sup>.

*Complementarity by construction.* The formal-informal dualism may lead to tautologies and trivial observations, as it represents a partition of the world in two and only two categories and with the 'formal' being defined by default, by what is non-informal and vice-versa. The informal sector, e.g., is a symptom of labour segmentation. Both categories are residuals of each

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<sup>26</sup> Paragraph 5 (1) of the ICLS Resolution of 1993, quoted in the OECD Handbook (2002, p. 162).

<sup>27</sup> See ILO (2002b), especially the chapter on statistics.

<sup>28</sup> Hussmanns (2004a).

<sup>29</sup> But not for the labour statisticians of the 17<sup>th</sup> ICLS (2003) who maintained the concept of informal sector and informal employment separate and the definition of the 15<sup>th</sup> ICLS as it is a part of the SNA93; see Hussmanns (2004b).

<sup>30</sup> See the many papers stemming from the World Bank RPED surveys; on the examples of Ghana, Kenya and Zimbabwe, Soderbom (2000) shows this heterogeneity of firms and the difference of results according to the industry and the firm-level factors.

other. For instance, enterprises are formal if they pay a corporate tax of some sort; enterprises are informal if they do not pay such a tax. As has been described since Hart's seminal article, the 'informal' sector is said to be a buffer against unemployment: it absorbs much of the unemployed workforce in times of recession, and the informal sector is a 'source of jobs for the poor'. Given that there are only two categories in this dualistic system, if the first category loses a certain quantity of workers, the latter will necessarily arrive in the second category, as they have nowhere else to go. This does not signal any particular characteristic of the informal sector— (such as dynamism or capacity of absorption).

### *Inconclusive characteristics differentiating the 'formal' from the 'informal'*

Discriminative capacity. Some criteria are insufficiently discriminatory establishing a dichotomy between the 'formal' and the 'informal' that is blurred by empirical observation. Dualism is challenged as the category of the 'informal' that cannot be defined by necessary and sufficient features. Depending on empirical situations and the perspective chosen, the literature thus reveals a lack of clear-cut differences between the two sectors. Differences may stem from differences of methods and definitional criteria, and especially the choice of macro or micro entry: at the macroeconomic level (i.e. national accounts) clear differences may be detected, particularly in the case of shocks, but firms may be heterogeneous and their behaviour disaggregated according to different criteria. Features respectively attributed to each sector may indeed be found on both 'sides'. Hence the supposed characteristics of each category are inconclusive, which may be expected given the heterogeneity of the phenomena observed at the levels of firms or sectors, as well as the loose conceptual boundaries of the definitions.

No dichotomy? Even the existence and depth of the divide between the two sectors remain debated. The dichotomy formal-informal is by definition a static conceptualisation, which hides the dynamics of employment processes and its determinants. From the early 1980s the concept of the urban informal sector was viewed as leading to excessive generalisations and adding little to the understanding and modelling of employment, e.g., the determinants of urban production technologies, the linkages, and the elasticity of substitution between formal and informal production<sup>31</sup>. In some studies the informal does not exist as such, as it is a dimension of unemployment and an endogenous response to government regulation<sup>32</sup>. Other studies, however, have shown that both sectors react differently to government policies<sup>33</sup>. The line of separation may be due to external factors, especially heavy state regulation, and should disappear if the latter were relaxed<sup>34</sup>. Other studies, however, see a discontinuity between informal and formal activities. Non-registration, for example, stems more from intrinsic features of informal enterprises than from governmental regulatory system, as is shown by their similarities in different countries<sup>35</sup>. The transition to formality is an unlikely process due to the intrinsic features of informal enterprises (e.g., low educational levels, inexperience in accounting and management, and tax avoidance strategies)<sup>36</sup>.

Registration. Informal sector is characterised by the unrecorded character of its activities. The latter is more a matter of continuum than a binary dichotomy. In many developing countries informal activities are registered by state services based on a series of documents. Informal

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<sup>31</sup> Stark (1982).

<sup>32</sup> Boeri and Garibaldi (2002).

<sup>33</sup> Patel and Srivastava (1996) on the case of India.

<sup>34</sup> De Soto (1989), Djankov et al. (2003).

<sup>35</sup> See McPherson and Liedholm (1996) on the similar lack of registration in the differing regulatory environments of Niger and Malawi.

<sup>36</sup> See Biggs and Srivastava (1996).

firms also pay taxes, such as marketplace taxes, licenses, taxes on equipment, and the like<sup>37</sup>. If most firms do not comply with the totality of legal obligations, in most cases at least a segment of their activity is registered with some agency of the state or indirectly through their relationships with a formal firm or financial institution. Certain survey samples are even constructed on the basis of the files kept in the revenues services, e.g. municipal licenses<sup>38</sup>.

*Flexible contracts.* Activities such as casual domestic work may involve both ‘informal’ and formal contracts, and the category of temporary contracts makes clear-cut distinctions hazardous. Labour ‘flexibility’ and high turnover are increasing features of employment and labour contracts in developing countries, e.g., for workers in agriculture and domestic services, who are often poorly paid and lack job security<sup>39</sup>. The decline of the unionised and permanently employed formal sector is sometimes described as the ‘casualisation’ or ‘informalisation’ of global labour markets. It is difficult to characterise them as formal or informal. Although written out, such contracts may be easily breached by the employer and lack protection of workers’ rights. *In fine* it is a third concept that is external to the conceptual dichotomy — the state — and a particular political economy that confer the character of informality to given contracts: it is the state and the enforcement of the rule of law which makes it so that flexible and temporary hiring falls in the informal or formal categories.

*Barriers to entry.* Low barriers to entry are furthermore supposed to characterise the informal sector (as in the ILO 1972 report on Kenya), as well as competitiveness and being unregulated. These do not constitute specific criteria and barriers to entry may indeed be features of the informal sector. In South Africa, for example – and this may be one of the explanations for the country’s high unemployment rate - the informal sector (i.e., self-employed and the casual wage work) displays higher incomes than the incomes of the unemployed people, but also erects barriers to entry for the unemployed, due to, among other things, obstacles to self-employment (especially credit facilities)<sup>40</sup>. Likewise, in some Sub-Saharan countries workers who were laid-off following the cuts in the civil service or the privatisation of state-owned enterprises remained unemployed over a significant period of time because they lacked the skills (experience, networks) to enter the informal sector, such as trading and craft industries<sup>41</sup>. Capital, credit, skills and experience, work as barriers in the informal sector as well.

The informal sector is in fact not made up of ‘informal’ networks, statuses, memberships or cooperation. Many of its activities are highly structured and stratified according complex social rules, and far from being a ‘residual’ it may be viewed as an entrepreneurial sector that requires accumulation of knowledge and other assets<sup>42</sup>, with informality being ‘ a secondary characteristic’<sup>43</sup>. Other assets, such as community membership — whether based on ethnicity, kinship, region, intergenerationally transmitted skills, or any other membership- or trust-building device —, may work as barriers to entry in particular segments of the informal sector. The latter may therefore be a fragmented market and split between insiders and outsiders<sup>44</sup>. Markets in developing countries are typically fragmented with different types of contracts that may be interlinked, e.g., tenancy contracts and those allowing access to other markets (goods, credit). The former contracts may therefore exclude the outsiders from the latter ones. As

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<sup>37</sup> As shown by Morrisson (1995): in his surveys, e.g., 2/3 of microenterprises and self-employed were paying taxes in Thailand and ¾ in Tunisia.

<sup>38</sup> See Oudin (1986) on a survey of the informal sector in Ivory Coast.

<sup>39</sup> On the informalisation of labour in South African agro-industry through flexible and temporary contracting, see Barrientos and Kritzing (2004).

<sup>40</sup> Kingdon and Knight (2004).

<sup>41</sup> On this kind of unemployment, see Younger (1996) on Ghana, Mills and Sahn (1996) on Guinea, Sindzingre (1995) on Benin.

<sup>42</sup> For this view, see Maloney (2004).

<sup>43</sup> Levenson and Maloney (1998) on the example of Mexico.

<sup>44</sup> As analysed by Lindbeck and Snower (1988) discussed by Bardhan and Udry (1999); on interlinkages, see the volume edited by Bardhan (1989).

Jacoby et al. demonstrate, for example, tenants of tubewell owners in Pakistan were charged lower prices for acceding to irrigation water than were non-tenants. Heterogeneity is a feature that has been long recognised<sup>45</sup>. It seems more appropriate to consider a plurality of informal markets rather than a single informal sector.

*Organisation, human capital, efficiency.* A low degree of organisation is similarly viewed as a trait of the informal sector. This is not the case, however, as informal workers may be highly organised in associations or unions, as in Sub-Saharan Africa<sup>46</sup>. The informal sector is also supposed to be characterised by lower levels of education. Education levels do not, however, constitute unambiguous elements of difference between the formal and informal sectors. Within a firm, 'informal' channels and networks in the hiring process may be used in addition to formal ones. As is well-known, large firms tend to be skill-biased, but surveys do not show that informal channels are associated with lower skills, as in Ghana – the key issue being the reduction of informational uncertainty on workers' abilities<sup>47</sup>. If there are differences, these are more complex than a simple dichotomy. As Bigsten et al. have shown, informal firms in Kenya are less capital-intensive, have little access to credit, their heads are less educated but they show higher investment and growth rates; they are less efficient than non-African-managed formal firms but more so than formal African firms,<sup>48</sup>.

*Income.* The informal sector is often typically characterised by lower levels of income relative to the formal sector. Informality has been described as a 'survival mechanism'. The informal sector, however, is heterogeneous above all. Classic studies have shown that there exist large variations in earnings within it<sup>49</sup>. Enterprise heads may have higher earnings than the average wage in the formal sector, but employees may earn less than the official minimum wage<sup>50</sup>. The self-employed have to be distinguished from salaried and contract workers. Studies on Latin America show that informal employment may be a preferred labour market status<sup>51</sup>. In Mexico, for example, the earnings of the self-employed are higher than salaried remuneration<sup>52</sup>, which is confirmed by numerous studies: in terms of wages and working conditions, workers in the informal sector are in a worse situation than informal entrepreneurs and workers in the formal sector<sup>53</sup>. Firm size is associated with wage effect and large firms (especially foreign firms) are generally associated with higher wages, though this has to be disentangled from the skill-bias and human capital effects<sup>54</sup>, which depends on the types of jobs<sup>55</sup>. The return on skills is more determinant in explaining wages differentials and unemployment. The dichotomies skilled-unskilled and employed-unemployed (as in South Africa) appear to be more relevant than formal-informal<sup>56</sup>.

Depending on the context, informal activities may yield higher earnings than formal ones, or sometimes lower. In contexts of formal wage decline and of the 'working poor' -, as has occurred in Russia, labour markets display the three statuses of formality, informality, and pluriactivity: the most precarious situation and with the highest probability of objective and

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<sup>45</sup> Jacoby et al. (2004) on Pakistan's Punjab region.

<sup>46</sup> E.g., Senegal, Côte d'Ivoire, Benin, Kenya, South Africa, among others; see Xaba et al. (2002).

<sup>47</sup> The Ghanaian data show that education acts as a discriminative signal when workers are hired through formal channels, see Strobl (2002).

<sup>48</sup> Bigsten, Kimuyu et al. (2000).

<sup>49</sup> See Mazumdar (1976).

<sup>50</sup> Lubell (1991).

<sup>51</sup> Carneiro and Henley (2002) on the example of Brazil.

<sup>52</sup> Maloney (1999), beyond the problems of the unmeasured characteristics.

<sup>53</sup> Ozorio de Almeida et al. (1995).

<sup>54</sup> See on Sub-Saharan Africa Strobl and Thornton (2002) and on labour markets, wages and employment more generally Mazumdar with Mazaheri (2000).

<sup>55</sup> For foreign firms' higher wage effect, see Lipsey and Sjöholm (2002) on the case of Indonesia.

<sup>56</sup> As is now shown by a huge literature; on return on skills and employment in Sub-Saharan Africa, see Teal (2000).

subjective poverty is to possess only one formal job<sup>57</sup>. In other contexts there may be relationships of substitution between the two sectors, with the informal sector absorbing shocks on account of its lower entry requirements (employment shocks, e.g., layoffs from the formal sector stemming from privatisation, the closing of uncompetitive formal industries after trade liberalisation, or income shocks, such as lower commodity prices resulting in increased urban migration). As crisis and reform in 1980s Sub-Saharan Africa have also been associated with contraction in demand, the overall effect has been to lower income levels in the informal sector<sup>58</sup>. Causalities involve several complex features: skills, firm size, sub-sector exposure to competition, being self-employed or salaried, among many others.

### *A dualism sometimes confused with other dualisms*

*Heterogeneous dualisms.* The formal-informal dualism is sometimes confused in the literature with other dualisms, although these refer to different economic processes. The formal-informal distinction has introduced additional confusion through its frequent assimilation with, e.g., the dichotomies of state-non state, public-private, small-large firms, written-unwritten rules, rigid-flexible norms, market-non market institutions (family, networks, trust), and Western origin-‘traditional’. The dichotomy between written and unwritten norms often conveys by analogy the related dichotomies of impersonal-personal and efficient enforcement-flexible unwritten norms, the latter relying on personal exchanges and mechanisms of trust and reputation, thereby allowing for more free riding and the impeding of collective action<sup>59</sup>.

The informal-formal dualism is also associated with the core model of economic dualism, i.e., the dualistic nature and imperfection of the labour market in developing countries, which was elaborated by Arthur Lewis in his analysis of the labour surplus moving from agriculture to industry and urban jobs - the unlimited supply of rural labour as a condition of industrialisation<sup>60</sup> - through a two-sector model (industrial vs. agricultural, capitalists vs. farmers who may not fully participate in markets and with less control by the state)<sup>61</sup>. In the modern sector relative wages of unskilled labour are exogenous and higher than in the rest of the economy. The concept of the informal sector then qualifies the non-agricultural and low-productivity sector where the unskilled work and are in excess supply vis-à-vis demand. This economic dualism may be measured by the relative productivity of agriculture and the rest of the economy. It has been assimilated with other dualisms, such as rural-urban income differentials. As Bourguignon and Morrisson show, however, these dualisms must be distinguished, since relative labour productivity and income differences are not the same variables (the total product is not entirely distributed to households, while non-labour incomes are under-reported)<sup>62</sup>.

*Confusing assimilations of dual concepts.* Over the past three decades these assimilations have contributed to the blurring of the concept of informality and have overlapped processes and notions that are not identical. Furthermore, these series of opposing notions do not constitute exclusive or stable distinctions; some dualisms may in fact be dimensions of other dualisms: e.g., unwritten rules may be rigid and found in large firms, or non-market norms (e.g., trust) may be a precondition for the functioning of markets. On the other hand, the interpretation of written rules may be flexible - this is the essence of jurisprudence and common law - whereas in

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<sup>57</sup> Kalugina and Najman (2002).

<sup>58</sup> On the example of Cameroun, Roubaud (1993).

<sup>59</sup> Among many others, Fafchamps (1992), Platteau (1994 and 2000), Greif (1989).

<sup>60</sup> Lewis (1954).

<sup>61</sup> Bardhan and Udry (1999); they view Preobrazhensky as the first theorist of the dual economy and the association of the agriculture sector with problems of taxation and surplus mobilisation and the industrial sector with greater state control.

<sup>62</sup> Bourguignon and Morrisson (1998).

developing countries — in Sub-Saharan Africa and elsewhere — a pervasive ignorance of officially written regulations-cum-permanent reinterpretation is a common state of affairs. In a political economy perspective, it may even be considered that ignorance of the law and the arbitrariness that ensues are political tools deliberately devised by governments.

### *Concepts that stem from measurement issues*

The ‘residual’ aspect is one of the problems inherent in the concept of the informal sector, i.e., the questionable direction of causality in the process of concept building. Concepts logically pre-exist vis-à-vis the methods and technologies that are devised for testing them. In order to elaborate a theory a concept is first built and then appropriate methods are elaborated in order to test it. In the case of the informal sector, methods often construct the concept, which has contributed to the plurality of its meanings as well as its different degrees of validity.

*A national accounts artefact?* There is a discrepancy between an artefact that is pertinent at the macroeconomic level and the plurality of meanings and criteria that [refer to the microeconomic level. The subsequent difficulty in establishing a correspondence between the macro and micro levels is an important dimension in the fuzziness of the concept. By its construction, the informal sector is a relevant notion at the macroeconomic level. It is indeed used as a category of national accounts and with specific criteria, e.g., the recorded character of activities. The concept of the informal economy is thus an object that has fallen into the realm of national accountants, and with similar fuzziness in regard to the referred facts. National accountants focus on the ‘non-observed’ economy, which brings together the ‘hidden’, ‘illegal’, ‘underground’ economy, ‘informal’, and ‘household activities undertaken for their own use’ (such as presented by the OECD and its joint publications with the ILO and IMF). The objective here is to measure this ‘non-observed’ economy and in a way that allows for international standards and comparisons within the 1993 system of national accounts (SNA93)<sup>63</sup>.

The objectives of measurement constitute incentives for consensual definitions rather than the opposite. Clear and accepted definitions have stemmed from the objectives of measurement, such as the definition of economic production according to the SNA93. National accountants’ objectives are to achieve exhaustive estimates of GDP – its level as well as rate of growth, which requires continuity in measurement and comparability with other countries methods and estimates. While many productive activities are observed and thus directly measured, ‘non-observed activities’ are to be accounted for and hence indirectly measured in the compilation of national accounts. As stated from the beginning of the OECD Handbook, what is crucial is ‘good quality national accounts’, which are ‘vital for economic policy making and research’. The extent of the coverage of economic activities is a key aspect of this quality, with the elements that are difficult to measure being identified and defined, e.g., the ‘illegal’, the ‘underground’, the household and the ‘informal’ production, which are dimensions of the ‘non-observed’ economy. These embody use of data from a wide variety of sources that can be brought together and reconciled within the SNA93 framework.

*Measurement objectives vs. concept?* Informal sector production—above and beyond other types of non-observed production (underground, illegal)—is defined in the SNA93 and the OECD-ILO-IMF Handbook as the ‘productive activities conducted by unincorporated enterprises in the household sector that are unregistered and/or are less than a specified in terms of employment, and that have some market production’. The 1993 ICLS on which the SNA93 is based defines the informal sector as ‘a subset of the household sector’ and provides ‘operational criteria’ that specifies the enterprises that belong to it, which include enterprises of employers

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<sup>63</sup> Elaborated under the aegis of the main international organisations (e.g. the EU or UN); see the Handbook on measuring the non-observed economy jointly published by the OECD, the ILO, the IMF and the Statistical Committee of the CIS, OECD et al. (2002).

and of own-account. The ICLS has recognised the difficulties of merging a political/analytical concept and a statistical concept<sup>64</sup>. Likewise, it highlights the two possible lines of definition of the informal sector: defining it through the relationship with the legal and administrative system, where informality is equated with non-registration, or as a specific form of production and enterprise organisation, which contradicts the first definition, as this form of production may include registered firms. The OECD ad hoc definition is tailored less for concept-building than for measurement objectives. Moreover, it obviously conveys the problems highlighted above: form as content parallel with competing other contents, additional difficulties of definition (e.g. ‘unincorporated’) and non-exclusive criteria (e.g. allowing multiple choices, as shown by expressions such as and/or, some).

*Bridging the macro and micro levels?* The macroeconomic/national accounts level and the microeconomic level exhibit divergent objectives and use heterogeneous concepts. National accountants aim at building conceptual frameworks and tables that are coherent, exhaustive and where inputs and outputs are harmonised and internationally comparable. Statisticians, for their part, seek to build the cleanest, most rigorous data. The informal sector as a macro concept is not built to have corresponding concepts at the microeconomic level, where the instruments mostly consist of household and employment surveys and surveys of micro and small enterprises. The targets of microeconomic surveys are not necessarily homogeneous with those of national accounts and macro-models. They are multiple and variable and may, for example, examine the dynamics of micro-enterprises and determinants of their creation, growth, duration, and disappearance, composition of employment, size, underemployment, types of supply and demand, and relationships with other elements of development such as human capital, access to the banking system, level of skills, and impact of macroeconomic policies<sup>65</sup>.

#### ***Determination of the ‘informal’ more by policy criteria than research***

The meaning and relevance of the concept of ‘informal’ has thus been significantly influenced by policy determinants, governmental objectives and criteria of operationalisation. As highlighted by Tanzi, national accounts are a matter of national interest (and may be ‘national tales’) and levels of the GNI and employment statistics are sensitive political issues<sup>66</sup>. In developing countries, furthermore, because of the role of donors in government behaviour via conditional lending and aid, international organisations have had a crucial role in the creation and expansion of the concept<sup>67</sup>.

*Policy and politics.* The intrinsic political dimension of policymaking has given rise to a set of normative studies of the informal sector that were determined by political and policy goals together with the provision of guidelines and recommendations, and contributed to the blurring of the concept. In developing countries, the meanings of the ‘informal sector’ have been influenced by thinking as to how it reacts to economic reform and its possible roles in policymaking and political functions. In the 1980s, this was compounded by debates on adjustment programmes and the latter’s critics, the political economy of reform, the role of the state (broadly, market-led growth, minimal state and support of the informal sector vs. support of the law and state-led development), and the roots of unemployment (e.g., in the comparisons between Latin America and Sub-Saharan Africa)<sup>68</sup>.

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<sup>64</sup> OECD Handbook (2002, p. 162).

<sup>65</sup> See Marniesse (2000).

<sup>66</sup> Tanzi (1999).

<sup>67</sup> As shown by McNeill (2004).

<sup>68</sup> See the critiques of the concept and the Bretton Woods institution approaches in Latin America and Sub-Saharan Africa in Lautier et al. (1991).

Policy and political issues that have influenced the meaning of the informal sector are, among other things, reflections on the promotion of entrepreneurship; the training of small-scale enterprises; the impact, legitimacy and appropriate type of government regulation and ‘business climate’<sup>69</sup>; and the debates on the private sector and entrepreneurship as a crucial source of growth. Much controversy remains as to the relevant direction of causality: the poor (individuals or firms) stay poor because they belong informal sector and because of its characteristics, or the informal sector is poor because of inappropriate government policies and excessive state intervention<sup>70</sup>.

*Reform implementation.* International organisations have also contributed to the shaping of the concept. Keith Hart’s core question was about income: the ‘chronic imbalance between income from wage employment and expenditure’<sup>71</sup>. Informal activities were analysed as opportunities for generating growth in the income of the poor and hence were as multiple as possible for a given individual. The dualism and focus on employment structure were developed later, in particular with the ILO.

The interest of the Bretton Woods institutions in the informal sector have been linked to crucial problems such as the accuracy of the calculations of GDPs and growth<sup>72</sup>, and the associated issue of the strengthening of the capacities of the statistical services through the implementation of censuses and surveys. Taxation has also been a key issue in the context of the fiscal crisis affecting most developing countries and the related stabilisation programmes, in particular for the IMF. For the latter, the informal sector is viewed as a significant factor in the low level of revenue and has been the subject of various reform proposals – e.g., presumptive taxation such as lump-sum taxation or taxation of production factors (e.g., physical capital, such as equipment)<sup>73</sup>.

## 2. CONTINUITY AND ALTERNATIVE DICHOTOMIES

The concept of informality thus has limited relevance, as it refers to heterogeneous activities and cannot be defined by discriminatory characteristics. This section first highlights the continuity between ‘formal’ and the ‘informal’ phenomena. Economic behaviour in its many dimensions—legal or unregistered, public and private, rural or urban—constitutes a continuum rather than a dualism based on artefacts such as ‘formal’ vs. ‘informal’. This continuity operates at the levels of cognition, of activities, and of institutions.

This section presents a more accurate dichotomy that relies on an alternative theory of institutions. Rather than the formal and informal, it distinguishes the forms and contents of institutions, and whether these institutions are formal or informal, as both types of institutions are characterised by particular forms and contents, variable degrees of obligation, and credibility. In this regard, ‘informal’ contracts and institutions exhibit few differences vis-à-vis formal ones, especially in terms of complexity and enforcement capacity.

### *The concept of informality: less a polarised dualism than a continuum*

*Contracts.* The concept of informality has been used in several sub-fields in economics, particularly in development microeconomics with notions such as informal exchanges,

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<sup>69</sup> These policy objectives centred on government regulation go beyond the issues of the informal sector, and include the question of unofficial economy; see, e.g., Johnson et al. (1998).

<sup>70</sup> As argued, e.g., by De Soto (1989).

<sup>71</sup> Hart (1973, p. 65).

<sup>72</sup> See, e.g., Bloem and Shrestha (2000).

<sup>73</sup> Taube and Tadesse (1996).

transactions, norms, contracts, arrangements that are interlinked, determined by informational constraints, and operating in fragmented markets (credit, insurance, labour, land). These arrangements are typical of developing countries and underlie, e.g., tied labour, sharecropping, microcredit, and insurance and risk-pooling mechanisms. In this literature informal exchanges and contracts are defined by contrast with formal ones, i.e. written and guaranteed by a rule of law, and therefore a state. These informal exchanges are implicitly equated with unwritten and 'traditional' ones, e.g., the 'bazaar economy' analysed by Geertz<sup>74</sup>. Informal arrangements, transactions and contracts are said to be reinforced by informal mechanisms, such as personal and repeated exchanges, trust, and reputation, in environments that are characterised by uncertainty, instability (e.g., of prices<sup>75</sup>, of institutions, of political regimes), short-term time horizons, problems of collective action and free riding.

The literature on informal transactions is sometimes confusing. Their synonymous character with 'unwritten' and 'outside-the state's-sphere' is rarely made explicit, nor are the theoretical consequences of this equivalence. Unwritten contracts may not always be informal, as are agricultural wage seasonal contracts. Informal transactions may not always be contracts, as are social norms, e.g., redistribution within solidarity networks that stems from social status and obligations. These transactions may entail reciprocity and work as 'informal insurance' – but this is only one of their functions and a function cannot be confused with a cause of a norm. These transactions may also entail no reciprocity, they may be not voluntary (e.g., informal gifts or lending to members of a kin group or to elders) and hence they do not really have the attributes of a contract<sup>76</sup>. As Udry and Conley have shown in their example of Ghanaian villages, functional economic networks may depend on 'fundamental social relationships' between individuals<sup>77</sup>. Pre-existing social statuses (through kinship, ethnicity) may ease trust rather than trust easing informal transactions. Informal transactions may in the first place be the actualisation pre-existing statuses, as the latter *ex ante* includes exchanges, obligations and the circulation of labour, goods and individuals<sup>78</sup>. On the other hand, social statuses and norms are non-market institutions, but they may be assets facilitating informal market transactions, e.g., the employment of kin in the farm or enterprise.

*Institutions.* The concept of informality has also been developed by Douglass North in his analyses of institutions and institutional change<sup>79</sup>. According to one of his well-known definitions, institutions are constraints that structure political, economic and social interactions and consist of informal - i.e., self-enforcing - constraints (sanctions, taboos, customs, traditions, codes of conduct, conventions, norms of behaviour) and formal regulations (constitutions, laws, property rights). North's views are explicit in that formal constraints are 'created', written and intentional, whereas informal constraints evolve over time and are unwritten. Institutions take the form of regulations as well as of ethical and behavioural norms, and their main role is to reduce uncertainty, introduce regularity and stability by 'establishing a stable (but not necessarily efficient) structure to human interaction'.

### *Cognitive continuity*

*Normative and credible representations.* The continuity between the 'informal' and the 'formal' operates first at the individual cognitive level. Individuals make permanent cognitive tradeoffs

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<sup>74</sup> See the pioneering studies of economic anthropology, e.g., the concept of 'bazaar' economy and repeated exchanges in a 'noisy' and uncertain environment, Geertz (1978).

<sup>75</sup> As shown by Berry (1993).

<sup>76</sup> See Destombes (2004).

<sup>77</sup> Udry and Conley (2004).

<sup>78</sup> See Platteau (1994).

<sup>79</sup> Among many others studies by North, see North (1990 and 1991); his views have been taken up by multilateral organisations such as the World Bank, see, e.g., Burki and Perry (1998).

between multiple obligations and norms from various origins (state, kinship, and so on) and assign relevance and credibility to particular institutions (e.g., state regulations or social norms) according to their assessment of situations. Individuals may be viewed as rational in the sense that they minimise the cognitive costs of mental processes given their limited information: at a cognitive level, the fact that rules are ‘formal’, written or come from the state (or do not) does not determine their relevance or credibility in a given situation. For a given rule, being ‘formal’ or ‘informal’ is less relevant than the many other attributes that orient individuals’ tradeoffs between following such or such a rule, e.g., the belief that certain rules and institutions are credible, relevant for them, and worth complying with. Thus the belief that state rules and institutions devised for the public good may not be credible in certain transition and developing countries, in contrast with the belief that local institutions are more relevant, e.g., better adapted, more widely shared, more equitable, and so on. When there is competition between norms (e.g., ‘modern’ and ‘traditional’), tradeoffs are determined more by the credibility that individuals may assign to a rule – and thus by their information on the rule’s various historical actualisations and cognitive path dependence.

Douglass North’s theory has over the years increasingly insisted on the cognitive dimension of institutions – coined as ‘cognitive institutionalism’. Mental models shape and are shaped by individual and collective learning processes and give rise to institutions<sup>80</sup>. Learning processes, however, are more determining for North as a basis of institutions than relevance and credibility, and he maintains the distinction between formal and informal institutions; the latter are the result of ‘spontaneous interaction’, whereas the former are the result of human design<sup>81</sup>. This may be questionable, as such a distinction does not create different individual cognitive processes of these institutions.

The relevance of and compliance with rules depend on situations and the perception that individuals have of them. In some contexts legal norms decreed by a state may be viewed as irrelevant, while other non-state institutions appear more pertinent. As is well-known in development microeconomics, this is often the case for social insurance against risk provided by social networks and ‘traditional’ institutions. In other contexts market institutions may be found more relevant than non-market ones (family, networks).

*The state as a discriminatory criterion?* The function of the state here is an important analytical element. Formal norms and contracts are indeed qualified as such not only because they are written or have a written component, but also because they are guaranteed by some governmental legal system. This contrasts formal norms with norms that are maintained ‘privately’ by social groups – e.g., customs, traditions – through bilateral and personal transactions and reputational mechanisms that prevent opportunistic behaviour. This distinction, however, may be inaccurate and superficial. On the one hand, in developed democracies, reputational mechanisms also constitute self-reinforcing mechanisms of contracts in parallel with government-enforced laws. Moreover, trust and cooperative networks may even be viewed as the foundation of modern economic transactions because the latter are based on specialisation and division of labour, as argued, e.g., by Paul Seabright<sup>82</sup>. This dissolves the dichotomous associations ‘informal-trust’ vs. ‘formal-state-writing’<sup>83</sup>.

On the other hand, in many developing countries political regimes and the state itself are deeply affected by problems of legitimacy rooted in their particular history. Governments’ decisions

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<sup>80</sup> See, e.g., North (1996) on institutions and cognitive science, Denzau and North (1994) on mental models and institutions.

<sup>81</sup> See Mantzavinos, North and Shariq (2003, p. 7).

<sup>82</sup> Seabright (2004).

<sup>83</sup> And if the economic function of law is to facilitate transactions, there is no reason for market economies to rely on the state for ensuring this function: in the neo-institutionalist perspective, the private provision of law may be viewed as more efficient than public provision; see Hadfield and Talley (2004) on the example of corporate law.

and policies – e.g., legal rules, economic reforms – may therefore not be perceived as credible<sup>84</sup>. Contracts guaranteed by state legal systems may be no more credible than contracts guaranteed by other ‘public’ and legitimate sources of authority<sup>85</sup> built over the historical *longue durée*. Time is indeed an intrinsic dimension of institutions<sup>86</sup>. Their rhythm of transformation is much slower than political change, as shown by Fernand Braudel and Kenneth Arrow<sup>87</sup>. In developing countries with weak institutions as in Sub-Saharan Africa, in the mental representations of individuals, the fact that contracts are ex ante enforced by a state does not necessarily make them more ‘formal’ than others deemed to be informal because they are backed by private parties and do not involve a legal apparatus of the state. This is particularly true for ‘collapsed states’.

In a perspective of methodological individualism—i.e., if rules are in the first place considered to be individual psychological phenomena—there is therefore a cognitive continuity between the ‘formal’ and the ‘informal’. In regard to the respect of contractual commitments and the choice of non-opportunistic behaviour (e.g., repaying a debt), individuals make (rational) trade-offs depending on the relevance of these obligations given their situation (the legitimacy of the obligation, the credibility of the enforcement, the rewards<sup>88</sup>) more than they do if the law or the contract happens to be written and is part of the legal system. The state in some developing countries may have such a low status and public enforcement of law may be so deficient, arbitrary or ‘privatised’ by political clienteles, that it has little cognitive relevance. Individual trade-offs are empirical decisions and there is no obvious reason to categorise them according to a formal-informal ad hoc criterion, such as being backed by the state (which is particularly the case in developing countries).

### *Continuity within the economic structure*

Secondly, continuity operates at an economic level, within and between activities, with civil servants and formal and informal entrepreneurs in developing countries maintaining well-known links. Several studies have shown the unconvincing character of the dichotomy and of the segmentation hypothesis<sup>89</sup>.

*Continuity within activities.* As is well-known, individual multiactivity is a dimension of poverty, uncertain environments and job precariousness. This was highlighted by Hart, who noted that if job duplication in the formal sector in Accra was common, multiple informal employment was ‘almost universal’ (with and without simultaneous wage employment<sup>90</sup>). Individuals make tradeoffs and may shift from the formal to the informal and vice-versa within the same job. In many developing countries, jobs in the civil service are valued in proportion to the opportunities and additional income that they allow in parallel activities. In Sub-Saharan Africa in the 1980s, economic crisis and stabilisation programmes (associated with the fall of investment and equipment expenditure and wage freeze) made free time and contact with the public the main assets of a post in the civil service<sup>91</sup>.

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<sup>84</sup> Because of policy reversals, lack of ‘agencies of restraint’, and so on; on problems of credibility, see, e.g., the classic paper by Collier and Gunning (1997) or Collier and Patillo (2000).

<sup>85</sup> In a seminal article, Ekeh (1975) has shown that in developing countries the public sphere of the state may be less legitimate than the other ‘public sphere’ of political and social norms that are the outcome of long historical processes and widely accepted.

<sup>86</sup> There has been an attempt to quantify this idea of a state credibility developing over time, which has been demonstrated for a long time by historians and political scientists; see Bockstette et al. (2002) on the relationship of the ‘state antiquity’, i.e. long experience with state institutions, with the quality of institutions and political stability.

<sup>87</sup> See the Preface in Braudel (1996); for a similar perspective, Arrow (1998).

<sup>88</sup> Wantchekon (2003) has thus shown that such ‘rational’ trade-offs favouring local relevance against the idea of a national public good were underlying the voting behaviour in Benin.

<sup>89</sup> Maloney (1999 and 2004).

<sup>90</sup> Hart (1973, p. 78).

<sup>91</sup> See on the example of Benin, Sindzingre (1995 and 1998).

In the private sector, entrepreneurs may simultaneously operate in both sectors. In environments characterised by high uncertainty, individuals implement rational risk-mitigating strategies in simultaneously pursuing several activities, e.g., trading and manufacturing, which may be both formal and informal (buying and selling in both sectors). They make tradeoffs according to the most profitable opportunities given the circumstances, e.g., changes in demand or transaction costs (e.g. enforcement of governmental regulations, bureaucratic harassment)<sup>92</sup>. As shown by Mazumdar, households are heterogeneous and may include members who work in both the formal and the informal sector (with the latter often not being the primary household earners<sup>93</sup>). Households are characterised by norms of exchanges (money, food, labour) between their members, whether they work in urban settings (firms or civil service) or in rural areas<sup>94</sup>. These exchanges are a dimension of multiactivity and have often operated as variables of adjustment in times of economic recession<sup>95</sup>.

*Continuity between activities.* As often highlighted in the literature, the border between legal, regulated, and informal activities within the sector or the firm is unclear, and linkages are numerous. Households decisions and hence linkages may depend on specific situations and the evolution of household characteristics (e.g., households may or may not decide to borrow from formal or informal institutions). These linkages work from informal to formal markets. In many developing countries temporary workers are hired via informal transactions, ‘informal’ enterprises work as sub-contractors for formal firms (e.g., in the construction sector), and formal firms supply street traders. There may be an explicit demand for informal employment from firms, the motives for which include profitability, tax evasion, control of the workforce, and flexibility<sup>96</sup>. Linkages also work from formal markets to informal ones, as the latter may use inputs produced in the formal economy<sup>97</sup>. Similarly, informal lenders may apply for bank credit for both their lending business and other activities<sup>98</sup>. In a somewhat different perspective, this notion of continuity is pervasive in the approach that views the informal sector as an endogenous outcome of excessive state regulation of labour and entry of start-up firms that prevail (sometimes with corruption) in the formal sector<sup>99</sup>.

Continuity between informal and formal activities is also highlighted by the theoretical perspective of value chains. Activities of production, transformation, exporting that convey a product – unprocessed commodities or manufactured goods – to the final consumer (local or international) involve segments and channels that resort to both the informal and formal sectors. In this perspective, flows of information are associated with flows of goods. At each stage of the supply chain firms negotiate in markets that are not always anonymous and may rely on long-term contracts, as is shown by chains involving, e.g., the export of cotton, coffee or fresh fruits and vegetables<sup>100</sup>. The informal sector is a dynamic phenomenon and is linked not only to the national economy but to the global economy, through its exports, reactions to adjustment reforms and trade openness (imports), and aid flows<sup>101</sup>.

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<sup>92</sup> See Sinzogan (2003) and the CAPE studies based on the CGE model of the economy of Benin.

<sup>93</sup> Mazumdar (1976); see also Harris (1978) on the example of South India.

<sup>94</sup> Households being better defined as ‘multispatial’ and ‘multiactive’, see Tacoli (2002).

<sup>95</sup> Mahieu (1990); Jamal and Weeks (1993).

<sup>96</sup> For an ILO view, see Van Eyck (2003).

<sup>97</sup> On Sub-Saharan Africa, Xaba et al. (2002).

<sup>98</sup> Nissanke and Aryeetey (1996).

<sup>99</sup> On the correlation between the size of the unofficial economy and the costs created by government regulation of labour and entry, Djankov et al. (2000 and 2003), De Soto (1989); see in a more political economy perspective, Meagher (1995) on Sub-Saharan Africa.

<sup>100</sup> See the IDS project, e.g. Wood (2001); Kaplinsky (2000), Ponte (2001).

<sup>101</sup> As shown by Wuyts (2001) on the case of Tanzania.

### *Continuity at the level of institutions*

Thirdly, continuity between the ‘formal’ and the ‘informal’ operates at the level of institutions. Even within his formal vs. informal framework, Douglass North has recognised that informal rules were evolutions, ‘extensions, elaborations and modifications’ of formal rules<sup>102</sup>, that both were correlated and formed a continuum where difference is a matter of degree. As highlighted by Fiori, the relations between formal and informal rules in North’s conception are gradualist and continuous, though conflicts may occur. Formal and informal institutions are logically and historically connected not only from informal institutions to formal ones, but in the reverse direction, with informal constraints evolving as extensions of formal rules, and with informal rules explaining the trends of historical change<sup>103</sup>.

*Forms and contents.* The formal-informal distinction rests on fragile theoretical ground. Whether in ‘traditional’ or state domains, both informal and formal institutions and norms are homologous under many dimensions. Institutions are characterised by their forms—their definition, names, modes of organisation—and contents—i.e. their meanings, functions, elements and sub-parts. These two levels are distinct and evolve differently. They are subject to continuous transformation due to historical processes (time) and their environments (space). Yet many studies view, in an ahistoric way, formal institutions (the form of institutions) as being the totality of institutions, e.g., legislated rules or formal institutions of property rights protection. These views are reductionist simplifications, as Dani Rodrik has argued<sup>104</sup>: the functions of institutions do not map into unique forms, as revealed by his example of effective property rights in China despite the absence of legal private property (and ineffective property rights despite the presence of legal rights in Russia)<sup>105</sup>.

Institutions have particular functions and meanings at a given point in time and space on account of their links and combination with other existing institutions, i.e., with other institutional forms and contents (‘formal’ or ‘informal’), and the broader environment—or because of the absence of certain institutions (e.g., the absence of a state and the rule of law endows village-level political forms with a different content from what they would have under a strong centralised state). Institutions are sustained or disappear based on their relevance and credibility in individuals’ minds and depending on the circumstances. Certain combinations may be less cognitively costly and more stable (e.g., the combination predatory regimes-social inequality more than predatory regimes-equality). Institutions may be linked by hierarchical relationships, i.e. conditioned by the existence of other institutions.

For example, the effective content of economic institutions such as central banks and stock exchanges depends on the ways they are articulated with other institutions (especially political institutions), which determines their effective independence, transparency, accountability, and so on. The functions and meanings of a political institutional form such as the rule of law likewise depend on an executive, a civil service, a legal system, judicial institutions, tax obligations that are credible and accountable, a penal system that is perceived as legitimate, and so on. Various studies have highlighted the relationships of complementarity or hierarchy that explain the emergence and transformation of institutions<sup>106</sup>. Whether political, economic or social, institutions are to be understood as a continuum of their multidimensional relationships with other institutions.

*An institutional form, several contents.* The form of an institution may be associated with different contents, including ‘informal’ institutions. In the case of reciprocity rules stemming from kinship rights and obligations (e.g., reciprocal assistance), individuals may assign a market

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<sup>102</sup> North (1990, p. 40).

<sup>103</sup> Fiori (2002).

<sup>104</sup> Rodrik (2004) criticising of the popular studies by Acemoglu et al., e.g. Acemoglu et al. (2001).

<sup>105</sup> Among several studies by Rodrik on this issue, see Rodrik (2003).

<sup>106</sup> This is one of the key concepts of Amable (2003).

content and use these ‘informal’ norms as efficient incentives and instruments within labour markets (as in the case of the exploitation of kin members in a farm or enterprise). Conversely, other individuals comply with these unwritten rules of assistance and allow an inactive workforce to subsist within their household, as in many Sub-Saharan African countries. Institutions are continuums of rules and are not defined by specific, necessary and sufficient sets of rules or types of enforcement. Functions and rules attached to the content of an institution may not be respected whereas the institutional form remains intact (examples being ‘informal’ systems of reciprocity and ‘formal’ judiciary institutions). ‘Formal’ institutions are under-determined in the same way as ‘informal’ ones. The forms and content of ‘formal’ written institutions under-determine their specific interpretation by individuals, the ways they shape individual behaviour, and the modalities of their transformation given changing environments and fluctuating cognitive representations. These modalities are unpredictable and observable only ex post.

*The deontic dimension.* Rules and institutions are cognitive representations that individuals find relevant (more appropriate, more credible, less cognitively costly given the environment). As norms, rules, and institutions, these cognitive representations have the particular property of being normative, i.e., of providing instructions for other representations and behaviour<sup>107</sup>. As Masahiko Aoki has shown, enforcement is, in order to be effective, an essential dimension of the rules of the game: for individuals rules must constitute binding cognitive states<sup>108</sup>. Institutions are not only sets of rules that evolve with events but also individual representations to which are attached meta-rules (deontic propositions<sup>109</sup>) that organise behaviour: e.g., obligations and prohibitions. The formal-informal distinction does not address this key issue of the deontic dimension of institutions, i.e., shared individual beliefs and that bind behaviour at a collective level. This dimension is the basis of the continuity between the individual cognitive level and the level of ‘external’ institutions that in turn organise collective behaviour, and thus underlies institutions’ sustainability. The fact that rules here may be formal or informal is of little relevance: both informal and formal rules receive their binding dimension from the presence of other institutions (e.g., an informal credit transaction from the kinship status of the contractors), are subjected to historical change, may be criticised, rejected, and so on.

*Politics.* Politics, path dependency, and history shape the particular actualisations and transformations of institutions in given settings. The capacity for an individual to exercise her rights and obligations is shaped by political relationships for both formal and informal institutions, as is often the case for land rights or women rights. For instance, informal justice displays institutional forms and meanings that are shaped by history in the same manner as are established courts of law. Informal capacities of coercion and judgement are as effective and enforceable by other institutions (e.g., providing legitimacy) as ‘formal’ justice and the exercise of power.

*Institutional forms and contents that are both informal and formal.* The dichotomous approach views formal institutions, norms and codes of conduct, as antagonistic with informal ones. In this view, formal norms may erase informal norms, or may be marginalised and merely coexist with widely accepted informal norms. Informal norms may also penetrate, shape and ‘capture’ formal ones<sup>110</sup>. This dichotomy and antagonism – the lack of ‘demand for the rule of law’ and the related absence of formal market-supporting institutions - has often been viewed as a factor in the failure of reform in transition and developing countries<sup>111</sup>.

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<sup>107</sup> This cannot be developed here: on this cognitive theory of relevance, see the pioneering work by Sperber and Wilson (1986); this has been examined in depth in Sindzingre (2003).

<sup>108</sup> Aoki (2001).

<sup>109</sup> For example, ‘one should do this..’ or ‘one is not allowed to do this...’.

<sup>110</sup> As shown on the example of corruption and ‘state capture’ (bribes to influence laws) by firms by Hellman et al. (2000).

<sup>111</sup> On such an explanation of the failure of economic transformation, see Stiglitz (1998), Hoff and Stiglitz (2004).

Rather than simply being partitioned into two categories, institutions include (based on a cognitive continuity) both ‘formal’ and ‘informal’ (traditional, path-dependent) organisations and contents of norms and codes of conduct. The ways exogenous legal systems are ‘transplanted’ (e.g., adaptation to internally developed legal systems) are more determining for their efficiency than for their particular contents<sup>112</sup>. In developing countries with weak anchoring and low credibility of Western-inspired state institutions, ‘formal’ institutions are ‘fed’ by contents, meanings, norms of behaviour that are ‘informal’ (‘traditional’, unwritten) together with formal ones. Formal contracts like bank loans, commercial credit, labour contracts, and corporate management, may include implicit meanings and rules that reduce the indeterminacy inherent in the form alone and determine their effective meanings in a given context. Informal contents provide ‘formal’ institutions with the necessary anchoring, relevance, and flexibility within societies, and are a factor in the historical transformation of formal institutions. As a vast literature has borne out, both formal and informal institutions are subjected to problems of imperfect information, incentives, interest, and trust as a condition of microeconomic transactions (market and non-market) and of economic growth at a more aggregate level.

Conversely, ‘informal’ institutions exchange with and borrow aspects from ‘formal’ institutions: e.g., economic (street vendors, moneylenders) and political (village politics) activities may integrate segments of banking rules or of parliamentary politics. These reciprocal borrowings are the essence of historical transformation.

***Informal vs. formal institutions as a questionable dichotomy: contracts, complexity, obligation***

Formal institutions such as laws and regulations back formal transactions such as formal contracts, whereas informal institutions are backed by trust, political norms, or ethical principles.

*Contracts: is ‘formal’ equal to ‘written’?* In the first place, it is difficult to differentiate types of transactions that characterise ‘formality’ as opposed to ‘informality’. Regulations and contracts are as pervasive in informal activities as in formal ones. Though the notion of ‘informal contract’ is used in the literature, the concept of contract is often equated with the formal contract (in fact with the written contract). The equation of the notions of being ‘formal’ and ‘written’ is, however, rarely analysed, though it is far from obvious and requires theoretical justification. Demonstrating the fact that because a rule is written its nature changes implies sophisticated considerations on the cognitive effects and functions of writing on human thought and behaviour.

This has been investigated by cognitive science and anthropology<sup>113</sup>, but rarely in development economics, which is not equipped to deal with these questions. The criterion of being written underlies a core type of contract, the ‘social contract’ that from Hobbes links the individual and the modern state in contractarian, or constitutional, liberalism. This contract may not be known and, whether formal or informal, the law has to be learned<sup>114</sup>. Conversely, trust or ethics may be viewed as indispensable elements in the efficiency of formal (written) contracts, as they reduce transaction costs, improve social cohesion, ‘ownership’ of reforms and credibility<sup>115</sup>. The types of transactions that are said to exemplify the dichotomy are not grounded in logical definitions

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<sup>112</sup> As shown by Berkowitz et al. (2003).

<sup>113</sup> In particular the pioneering studies by Jack Goody, who interestingly views writing as ‘formalising’ the system of language and its ambiguities and allowing for the emergence of categorisation; among others, Goody (1986).

<sup>114</sup> As shown by Engel (2004).

<sup>115</sup> This is highlighted by several theoretical perspectives, e.g., constitutional political economics, which shows the links between moral and interests, as in the work of Viktor Vanberg, or economics and the studies on the links between social cohesion and growth (e.g. Dani Rodrik).

and with exclusive attributes. Other criteria have aroused more interest in the literature, such as the incomplete character of contracts, whether formal or informal<sup>116</sup>.

*Complexity.* Secondly, ‘informal’ phenomena include highly formal rules and which may display extreme complexity. This is shown by innumerable examples of kinship, political, and religious and ritual systems in non-Western societies, such as marriage and inheritance rules, and accession to political positions, which may involve years and large social groups. ‘Informal’ contracts may be viewed as very ‘formal’, with their unwritten character appearing to be an incidental and superficial criterion. The very notion of contract entails a capacity to commit, and hence some credibility, predictability of action and stability of anticipations in the space of events that are covered by the contract, whether it is formal or informal. As one is reminded by the variety of contractual forms in developed countries and depending on the region (e.g., between the United States and East Asia<sup>117</sup>) the formal-informal distinction does not establish a relevant difference in regard to the attributes of the concept of contract. Likewise, the domain of contracts (markets vs. non-market exchange) does not constitute a significant discriminatory criterion, and informal contracts may efficiently cover market transactions as well as non-market ones in an uncertain environment, as one may observe in any marketplace in a developing country<sup>118</sup>.

*Coercive capacity.* Thirdly, informal, unwritten and customary norms, when shared by groups of a significant size, are as coercive, obligatory and linked to sanctions as are written norms. Conversely, the written rules’ dimension of obligation may be ignored and not followed by the majority, especially in developing countries with weakly institutionalised states. Group membership and hence shared group norms are coercive because they may constitute the only norms (as in ‘failed’ and ‘weak’ states). More generally, group affiliations and shared norms are coercive because they provide low-cost trust in environments that are characterised by uncertainty and instability, together with high costs (e.g., exclusion) in the event of a breach of norms and opportunism as well as information transmission, tracking of free-riders and coordination of punishment supporting a reputation mechanism<sup>119</sup>. These coercive dimensions work according to self-fulfilling mechanisms, e.g., economic losses in case of non-compliance.

As shown by Fafchamps in the case of commercial contracts in Ghana, informal contracts are subjected to credible enforcement mechanisms because of motives such as preserving personal relationships and trust (which is not necessarily the same as reputation). The use of formal enforcement, such as courts, may even be viewed as less relevant than informal enforcement<sup>120</sup>. The existence of more business-supportive legal institutions may be associated with higher incidence of breach and use of formal lawyers and courts, as revealed by a survey on six Sub-Saharan countries<sup>121</sup>. Informal contract enforcement may similarly be more efficient, as in the case of informal lenders who may enjoy much higher loan repayment rates than formal lenders without litigation in courts<sup>122</sup>. A study of labour market institutions in the construction sector in Egypt has shown that customary institutions may shape relations more significantly than formal ones<sup>123</sup>. This coercive aspect is stable where state enforcement of law is deficient and there is thus little competition among several systems of rule enforcement. The presence of states is not, however, pertinent in order for these mechanisms of enforceability to function, and personal exchanges as well as impersonal exchanges have historically antedated states<sup>124</sup>. The various

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<sup>116</sup> For a presentation of the theory, Salanié (1997).

<sup>117</sup> This is explored by a vast literature on business networks and corporate governance.

<sup>118</sup> As shown by the many studies by Fafchamps, Bardhan, Udry, Platteau, among others.

<sup>119</sup> Pioneering studies being Akerlof (1976) on the reasons of the persistence of the caste system, and Greif (1993) on coalitions and contract enforcement.

<sup>120</sup> Fafchamps (1996).

<sup>121</sup> This is the case in Zimbabwe, see Bigsten, Collier et al. (2000).

<sup>122</sup> As shown by Aryeetey (1998) on the example of four Sub-Saharan African countries.

<sup>123</sup> Assaad (1993).

<sup>124</sup> As shown by Greif (1997) on the emergence of impersonal exchange in pre-modern Europe.

mechanisms underlying compliance with rules, the size and organisation of groups (such as informational exchanges and reputation as a tool of enforcement) appear more relevant than the dichotomy formality (state enforcement, writing) vs. informality for understanding the effectiveness of norms and contracts.

***Methodological consequences: the limits of causalities based on econometric exercises***

Finally, these analyses explain the often-inconclusive character of models that include informality as one of their variables. This is the case with the macro-models that aim at estimating and measuring the size of the hidden economy and the informal sector. As critics have observed, these models are very broad and use questionable hypotheses, proxies and indicators (e.g. a single indicator such as household consumption of electricity or changes in the patterns of currency demand). These approaches are obviously reductionist and make generalised hypotheses on the links between microeconomic behaviour and macroeconomic categories (e.g., the hidden economy at a national level). Models oversimplify the complexity of the relationships between the two levels without convincing economic theories of the relationships that justify these approximations, e.g., on the relationships between state regulation, taxation, tax evasion, among other things<sup>125</sup>.

The limitations of uncritically relying on and quantifying notions such as informal institutions—or even institutions in general—may also affect growth models and econometric regressions. If models use the concept of ‘informal’ as a type of employment, informality constitutes by construction an endogenous category vis-à-vis the notion of formality, each notion being the residual of the other, and with problems of boundaries. Informality brings into a conceptual category heterogeneous phenomena which may not share common traits. If models use the concept of informal as a type of institution or arrangement, these institutional variables refer to institutional dimensions (formal or informal) that are not discrete entities or numbers and therefore cannot constitute variables that have stable meanings and references in time and space (e.g., trust)<sup>126</sup>. Some institutional phenomena may be described as numbers, e.g., recourse to the judiciary or political regime instability, but other cannot, such as credibility or illegitimacy. Proxies are also often questionable (e.g., the number of known persons for approximating a network, rate of urbanisation or colonisation for institutionalisation) and as noted by Rodrik, an instrumental variable is not a theory or an explanation<sup>127</sup>. The concepts and processes related to institutional transformation and political power are more complex than these kinds of model usually assume, whether they relate to ‘formal’ or ‘informal’ institutions<sup>128</sup>.

## CONCLUSION

Human cognition is configured in such a way that conceptual dichotomies are easier to handle than complex reasoning. By its construction a dichotomy is a reductionist scheme, as it reduces the multidimensionality of facts to two categories. Some conceptual dichotomies correspond to empirical phenomena, such as agriculture-industry or rural-urban. Other dichotomies, though they seem to constitute evidence, give rise to as many problems as the solutions they are aimed to provide, such as market-non market. This paper has shown that the informal-formal dichotomy and the related concept of informality reveal little that is useful in the understanding of the phenomena to which they have been applied. The two categories gather empirical facts

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<sup>125</sup> As highlighted in the OECD Handbook’s Introduction.

<sup>126</sup> See Durlauf and Quah (1998) on the use and abuse of growth regressions.

<sup>127</sup> Rodrik (2004).

<sup>128</sup> This is developed in Sindzingre (2004).

that are very heterogeneous. The concept of informality has constituted a broad term that has different meanings according to objectives and sub-disciplines (e.g., national accounting and development economics). Furthermore, characteristics of informality that could be specific to it are difficult to find. The concept has weak discriminatory power. As such it has an unstable definition and a weak heuristic capacity either for analytical reasoning or for economic modelling.

Nevertheless it has ‘worked’, perhaps because of a reductionism that assimilates categories of enterprises, economic behaviour such as the non-payment of taxes, types of institutions and contracts (and their written or unwritten characters), and analytical perspectives –(national accounting, labour economics or institutional economics). It would be more rigorous to return complexity to empirical facts, keeping as many different concepts as there are facts, levels of analysis and theoretical questions. This would also be helpful in understanding the multiple constraints and dimensions of development.

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