The informal sector in transition: Tax evasion in an institutional vacuum
Gerxhani, K.

Citation for published version (APA):
Chapter 2

The Informal Sector in Developed and Less Developed Countries:
A Literature Survey

"There are probably few people who do not, at some level, have mixed feelings about informal economic activity"

- HARDING and JENKINS (1989:174)

2.1. Introduction

Once upon a time, no attention was given by economists to economic activities carried out outside the formal framework of the economy. Sociologists and anthropologists were the only ones who seemed to consider the existences of such activities. In the 1950s and 1960s, however, the informal dimensions of organizational life became increasingly recognized as important and were accepted as a commonplace topic for research (Blau and Scott, 1963; Gouldner, 1954).

However, an accurate academic meaning was not given to this neglected phenomenon until it was analyzed in 1972 by the International Labor Office (ILO), under the name informal sector.\(^1\) As a matter of fact, the informal sector concept originates from a study in a Third World context (Hart, 1971).\(^2\) It was in the Third World countries that the informal sector was initially observed and studied, followed by an increased interest in developed countries. Eventually, significant studies about developing countries, a few on former socialist countries (mainly about the former Soviet Union), and more recently (in the last ten years)

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\(^1\) Many taxonomies have been used to name this phenomenon, since then. Nevertheless, there is no universal terminology, yet. We will adopt the generic term 'informal sector' in this literature survey, and extensively discuss its various meanings and dimensions.

\(^2\) More details will be given later.
about transition countries started to appear. These studies have recognized that the influence of the informal sector in these countries is much more significant than in many other countries.

Although the significance of this sector has varied in different periods and for different countries, society has become more and more aware of the importance of studying it. Several studies define the informal sector in distinct ways and this is one of the reasons why these studies are considered inconsistent. The academic thought about this phenomenon has developed from the earliest studies, which contemplated the informal sector as a marginal or residual activity, to recent ones, which consider it a central aspect of the economic and social dynamics of any country, but especially of the less developed ones. The main issue discussed in the literature has been the significance of the informal sector and its relation to the formal economy. Many studies have contributed to this issue, but there are still contradictions and inconsistent outcomes. This is most obvious when one compares studies of the informal sector in developed countries with studies of the same phenomenon in developing and transition countries. Although the literature is relatively scarce, this research aims at studying more deeply the informal sector in transition countries. Nevertheless, it is of great importance to see how academic thought progressed as the result of numerous studies in all countries. Hence, this survey will discuss all these historical developments in the literature on the informal sector and their contributions to economic, political and social theory. In addition, due to the fact that a substantial part of this thesis is dedicated to the analysis of tax evasion—one aspect of the informal sector—the literature coverage of this topic will be particularly emphasized.

This survey is organized by distinguishing studies of the informal sector in developed countries from studies on less developed countries.\(^3\) The next section provides a summary of the origin of the informal sector concept. Section 2.3 describes the criteria used to define various aspects of the informal sector. Section 2.4 presents the advantages and disadvantages of the informal sector, followed by some policy implications with respect to its significance.

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\(^3\) From now on, 'less developed countries' will refer to 'developing, centrally planned and transition countries'. According to a recent personal suggestion of Jim Thomas, the 'informal sector' should be called the 'black economy' for developed countries, the 'informal sector' for developing countries, and the 'second economy' for transition countries. The main contribution of this chapter is exactly the recognition of a distinction between these groups of countries, without focusing on the terminology used. Therefore, in line with most of the literature, the term 'informal sector' will continue to be used.
Some of the theories about the informal sector follow in section 2.5. Empirical studies are discussed in section 2.6. Section 2.7 concludes.

2.2. The genesis of the informal sector concept

Keith Hart (1971, 1973) - a social anthropologist - was the first person to bring the term informal sector (in a Third World context) into the academic literature. He introduced the concept of the informal sector to describe a part of the urban labor force, which works outside the formal labor market. Hart considered the informal sector as almost synonymous for the categories of small self-employed individuals. This was thereafter typically used to refer to ways of making a living outside the formal wage economy, either as an alternative to it, or as a means of supplementing income earned with it (Bromley and Gerry, 1979). In addition, Hart distinguished formal and informal income opportunities on the basis of whether the activity entailed wage or self-employment, implying that wage-earning employment is a characteristic of the formal sector only. Even though Hart's original notion of the informal sector is limited to the self-employed, the introduction of the concept made it possible to incorporate activities that were previously ignored in theoretical models of development and in national economic accounts (Swaminathan, 1991). This was an important characteristic of the subsequent use of the term.

In spite of the early work by Hart, the pioneering research on the informal sector is widely considered to be the report of the International Labor Office on employment in Kenya (ILO, 1972). Informality in this report is mainly characterized by the avoidance of government regulations and taxes. Initially, the ILO considered the main aim of the informal sector to be the provision of subsistence to families. It related the growth of the informal sector to its positive effects on the labor market and the distribution of income. As a consequence, it argued that solving the problems of the informal sector is only possible if the problems in these domains are solved. After this initial study, the ILO conducted numerous research studies on the informal sector, bringing new developments to the field over time.

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4 It should be mentioned, however, that a casual labor market of a somewhat similar nature (informal) has also been identified in London in the 18th and 19th centuries (George, 1966; Stedman Jones, 1984).

5 It has been argued that this approach conforms with Keynesianism which believes in State intervention (Guerguil, 1988).
Chapter 2

One of these new developments was the recognition of a new aspect of the informal sector,\(^6\) which is its dynamism and potential for economic growth and employment.

Initiated by the well-known research of H. de Soto (1989) and followed by many others, the conceptualization of the informal sector took yet another meaning. This new course of research studied the informal sector in a regulatory framework. In this approach, the legal status is the main element distinguishing informal from formal activities. It relates the emergence of the informal sector to the policies applied and to the transaction costs. It suggests, therefore, the deregulation of the market and the almost complete abolition of State intervention. A great contribution to the same line of thought is the work of Thomas, who used three main criteria – (a) are market transactions involved?; (b) are the goods and services being produced legal?; and (c) are the methods of production and/or distribution legal? - as a way to distinguish different types of informal activities. He tried to make this distinction since 1982. However, a more complete picture of this distinction is given in Table 2.1, as part of his recent work on this topic in 1992.

Table 2.1: The structure of informal economic activity

<table>
<thead>
<tr>
<th>Sector</th>
<th>Market transaction</th>
<th>Output</th>
<th>Production / Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Household</td>
<td>No</td>
<td>Legal</td>
<td>Legal</td>
</tr>
<tr>
<td>Urban Informal</td>
<td>Yes</td>
<td>Legal</td>
<td>&quot;Quasi-Legal&quot;</td>
</tr>
<tr>
<td>Irregular (“Black Economy”)</td>
<td>Yes</td>
<td>Legal</td>
<td>Illegal</td>
</tr>
<tr>
<td>Criminal</td>
<td>Yes</td>
<td>Illegal</td>
<td>Illegal</td>
</tr>
</tbody>
</table>

Source: Based on Thomas (1992, p. 6, Table 1.1).

Several theories, methodologies, attitudes and policy implications followed in due course, but these initial approaches are recognized as the basic roots of studies of the informal sector.

2.3. Definitions

2.3.1. Studies about developed countries
The literature on the informal sector is fraught with terminological confusion (Harding and Jenkins, 1989). Some of the early descriptions of the informal sector are the ‘bazaar-

\(^6\) Note that the prior belief was that the ‘informal sector’ was composed only of marginal activities.
economy' and the 'firm-centered economy' (Geertz, 1963); the wartime notion of the 'black market' (Smithies, 1984); popular conceptions about the criminal 'underworld', or images of 'the world turned upside down'. Feige (1989) introduces the term 'underground economy', whereas many others have labeled it subterranean, shadow, informal, hidden, parallel, black, clandestine, second, household, etc. The generation of these concepts is explained by the simple fact that what Feige calls the 'underground economy' is a mixture of multi-fold activities. This explanation clarifies to some extent the terminological confusion. In addition, it illustrates why different domains (e.g. labor economics, sociology, finance, macroeconomics, statistics, criminology, etc.) give it a different meaning. It appeared that no single definition of the underground economy could serve all these diverse domains (Feige, 1989). Therefore, researchers gave up trying to formulate a unique definition, but instead, based on several criteria, they have attempted to define the informal sector in accordance with the problem at hand.

A lot has been written about the definition of the informal sector. However, for reasons of brevity, we will summarize the criteria used in various studies to formulate the informal sector and relate these to various definitions. Our analysis is summarized in tables 2.2 (studies of the informal sector in developed countries) and 2.3 (studies of the informal sector in less developed countries).

The selection of researchers listed in the tables is based on several elements, for example, the period of study, the distinct criteria used to define the informal sector, the new developments brought into the field, and the international importance of their findings. Although a survey like this can never cover all the studies in a field, the work referred to in tables 2.2 and 2.3 is generally considered to cover the main studies with respect to the definition(s) of the informal sector.

In both tables, we distinguish various definitions by using three main criteria and various sub-criteria. We have adopted the main criteria from Harding and Jenkins (1989). These describe 'the institutional patterns by which the society shapes the informal sector'. They are political, economic and social. The more specified sub-criteria, which are used to define the amalgam of the informal sector activities, vary across the main criteria.
Table 2.2: Criteria used to define the informal sector in studies of developed countries

<table>
<thead>
<tr>
<th>Authors</th>
<th>Political (Legal Aspects)</th>
<th>Economic</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>gove,rnment regulation</td>
<td>tax evasion, or status of labor (unregulated, no social benefits, work conditions, etc.)</td>
</tr>
<tr>
<td></td>
<td>illegal activities</td>
<td>activity's size (small scale of operation)</td>
</tr>
<tr>
<td></td>
<td>national statistics (GNP)</td>
<td></td>
</tr>
<tr>
<td>Breman (80)</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Feige (79-89)</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Gershuny (83)</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Tanzi (82-89)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Castells, M. &amp; Portes, A. (89)</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Harding &amp; Jenkins (89)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Renooy (90)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intern. Rev. Serv. (IRS) (79)</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Inter. Lab. Off. (ILO) (72 on.)</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Swaminathan (91)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(* refers to the use of the criterion to define the informal sector in less developed countries.  
(+) refers to the inclusion of the criterion in defining the informal sector;  
(-) refers to the explicit exclusion of the criterion in defining the informal sector.  
(*) refers to those authors who have contributed to define the informal sector in both developed and less developed countries.)
Table 2.3: Criteria used to define the informal sector in studies of less developed countries

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Political (Legal Aspects)</th>
<th>Economic</th>
<th>Social</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>governmt. regulation</td>
<td>illegal activities</td>
<td>national statistics (GNP)</td>
</tr>
<tr>
<td>Hart (71, 73)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intern. Lab. Of.’ (ILO) – (72 on.)</td>
<td>+</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grossman (82)</td>
<td>+</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Banerjee (82)</td>
<td>+</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Beneria (89)</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Renooy (90)</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Swaminathan’ (91)</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Kaufmann &amp; Kalibera (96)</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Commander &amp; Tolstopyatenko (97)</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Anderson (98)</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
</tbody>
</table>

(*) refers to the use of the criterion to define the informal sector in less developed countries.
(+*) refers to the use of the criterion to define the informal sector in less developed countries.
(-) refers to the explicit exclusion of the criterion in defining the informal sector.
(‘*’) refers to those authors who have contributed to define the informal sector in both developed and less developed countries.
The main sub-criteria used with respect to the political aspect of the informal sector are:

1. government regulation;
2. illegal activities; and
3. national statistics (GNP).

The main idea behind this classification is that it captures the influence of the informal sector [involving lack of government regulation, illegal activities and consequently substantial errors in measuring the national product (GNP)] on politics. The majority of researchers selected have used the sub-criteria of government regulation to define the informal sector (cf. tables 2.2 and 2.3). Feige (1981), as we will see later, emphasizes the 'national statistics' aspect among the several other criteria he uses.

Although the introduction of the political aspect in the study of the informal sector was an achievement, the basic criterion - which has also received most attention - is the economic one. The sub-criteria used in this category are numerous. However, we will try to cover the most notable ones, which consist of the following:

(1) labor market or status of labor (including undeclared labor, lack of social benefits, sub-minimum wages, poor working conditions)

As expected, this criterion is essential in defining the informal sector. Many studies have based their notion of the informal sector on its consequences for the labor market. Based on this criterion the informal sector is the sum of all income-earning activities with the exclusion of those that involve contractual and legally regulated employment. Among others, Harding and Jenkins (1989), Renooy (1990) and especially the International Labor Office (ILO) emphasize this criterion.

(2) unreported income or tax evasion

Tax evasion appears to be another essential sub-criterion in the economic category. The general definition of the informal sector using this criterion describes it as the sum of all taxable money income (e.g., from self-employment, wages and assets from unreported work related to legal services and goods), unreported with the intention to evade taxes. Evidently, a combination of economic and legal aspects takes place when the element of tax evasion is
used in defining the informal sector. A recent institutional approach defines the unreported economy as those activities that circumvent or evade the institutionally established fiscal rules as codified in the tax code. Several researchers, such as Allingham and Sandmo (1972), the Internal Revenue Service (IRS, 1979) in the United States, Feige (1981, 1990), Tanzi (1982-1986), Cowell (1990), Alm (1991) and Schneider and Enste (2000), specifically emphasize this criterion.

(3) size of activity

This criterion used to be quite dominant, especially in the early research on the informal sector. The size of an activity was usually measured by the number of people employed in it. For example, S.V. Sethuraman (1976) claims that employment of less than ten persons should be considered part of the informal sector. As a result, the small-scale of operation is considered one of the main features of the informal sector activities. This criterion has been particularly helpful in carrying out enterprise surveys. However, table 2.2 shows that not many researchers of the informal sector in developed countries have used this criterion.

(4) professional status (i.e., self-employed, employer, family worker, apprentice, wage employee)

This criterion is meant to distinguish between wage employees and non-wage employees involved in the informal sector activities. Informal workers are defined as 'the sum of the self-employed, unremunerated family workers and domestic servants'. Since the beginning (Hart, 1971, 1973), self-employment is considered to be a dividing criterion. Despite its early frequent use, the 'professional status' criterion was not popular for a while. However, it became useful again in the analysis of population censuses and employment surveys in the early 1990s, according to Charmes (1990).

(5) regulation or registration of an activity

Definitions based on regulation consider the relationship of an activity/enterprise to government regulation. Swaminathan (1991), who has elaborated this criterion most, defines

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7 Note that in tables 2.2 and 2.3, this is the criterion used by the highest number of researchers.
the informal sector enterprises as establishments which are unregistered and unlicensed.\textsuperscript{8} However, he does not seem to be the only one. Many others share the same view (see tables 2.2 and 2.3). Regulation is inclined to be a frequently used criterion in defining the informal sector activities.

(6) national statistics or GNP accounts\textsuperscript{9}

Another reason to study the informal sector is related to the distortions this sector causes in measuring the national accounts (GNP). Feige (1981), who is one of the main supporters of this criterion, defines the informal sector as ‘all economic activities, which because of accounting conventions, non-reporting or under-reporting, escape the social measurement apparatus, most notably the GNP accounts’. As table 2.2 also shows, Feige combines two criteria – tax evasion and national accounts – in defining the informal sector, where the causality could be either way.

The third institutional criterion used in defining the informal sector is the social one. Its main sub-criteria are:

1- social networks and ease of entry

Surveys on the informal sector indicate that ‘A friend of a friend’ are the key words in this sector. Breman (1980) emphasizes that the social network is very significant in dividing the informal sector into different types. In addition, the International Labor Office (ILO) and various other researchers have often stressed one of the main advantages of the informal sector - ease of entry – which has also been considered as a defining feature of the informal sector. Tables 2.2 and 2.3 show that about half of the authors use this criterion in their definitions.

2- autonomy and flexibility

Many informal sector participants, especially in developed countries, choose to participate in the informal sector because they find more autonomy, flexibility and freedom in this sector

\textsuperscript{8} License procedure refers to obtaining a permit from state authorities in order to operate; while registration procedure refers to registering the activity according to the state rules.

\textsuperscript{9} Remember that this sub-criterion has consequences in politics as well.
than in the formal one. In other words, participants have the freedom of operating their own business; they have flexibility in determining hours or days of operation; they can use and develop their creativity. About half of the researchers selected in tables 2.2 and 2.3 seem to share this criterion.

3- survival

This criterion means that the occurrence of informal economic activities is related to the survival needs of its participants. Survival does not appear to be an aspect used in defining the informal sector for developed countries (see table 2.2). Conversely, Castells and Portes (1989) and ILO (1972 onwards) mention explicitly the exclusion of this criterion in defining the informal sector in these countries. It is important to mention at this stage that the occurrence of the survival criterion has economic consequences for accumulation and growth. A discussion of this relationship will be provided later.

2.3.2. Studies about developing and transition countries

As mentioned previously, the informal sector concept originates from a study in a Third World context. This is basically due to the bigger significance this sector has had and still has in developing countries. There are many studies on the informal sector in developing countries, whereas the number on transition countries has increased only recently. It should be noted that the informal sector also existed in the former centrally planned economies, which are now in transition. However, considering the relative isolation of these countries in that period, there are only few studies on this phenomenon in socialist regimes. These are included in the discussion below.

Table 2.3 lists a considerable number of researchers who have studied the informal sector in less developed countries. This table indicates that studies of less developed countries use more or less the same criteria as studies of developed countries. However, considering several differences in the stages of development in these two groups of countries, differences regarding the informal sector and its definitions are expected.

10 Studies indicate that the lower the level of a country's development, the larger and more important its 'informal sector' (Charmes, 1990).

11 This is discussed further in the section 2.5.2.
According to the table, studies of less developed countries support the political criteria in the same way as studies of developed countries do. With respect to the economic criteria, there are some differences. For example, the sub-criteria ‘size of activity’ or ‘small scale of operation’ is used more in studies of less developed countries. This is most likely because small-scale activities dominate in the informal sector of less developed countries. Distortions caused by the informal sector in measuring national account (GNP) do not seem to have attracted much attention. However, the fact that Kaufmann and Kaliberda (1996) and later Anderson (1998) use it, shows that research studies on these countries are becoming more aware of its importance.

As for the social aspect of the informal sector, it is worth mentioning the emphasis that Grossman (1982) gives to the importance of social networks in the informal sector of planned economies. In addition, his study points out another typical feature of the informal sector in socialist countries, which is the strong linkage between the state and non-state activities. These two features seem to have remained even during the transition period.12 Furthermore, tables 2.2 and 2.3 indicate a big difference between the two groups of countries regarding the use of ‘survival’ sub-criteria in defining the informal sector. Various studies have shown that contrary to developed countries, the informal sector in less developed countries generates low income and little if any accumulation. Furthermore, it is characterized by labor intensive and low technology, and it is mainly a survival sector. However, this issue is still subject of an open debate. Therefore, we will elaborate further on it in a separate section about the significance of the informal sector.

2.3.3. Summary

We have shown that several criteria have been used to describe the diverse forms of appearance of the informal sector. Both the existence of these various forms and the several criteria yield a large variety in definitions. Understandably, the existence of a variety of descriptions/definitions is confusing, as Renooy (1990) has pointed out. In addition, this large variety of definitions makes it difficult to provide a uniform picture of the field. However, consensus amongst the researchers on what is being studied has grown.

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12 For more evidence, see Kaufmann and Kaliberda (1996).
The two groups of studies (on developed and less developed countries) converge with respect to the use of some basic criteria – undeclared labor, tax evasion, unregulated or unlicensed enterprises, illegality or criminality – in defining the informal sector. The essential divergence is related to the use of the ‘survival’ criterion. Contrary to research on the informal sector in developed countries, studies on less developed countries have shown that the informal sector is more often seen as an opportunity for survival. Consequently, this sector does not appear to have potential for economic growth in the latter countries.

The studies discussed have contributed to the general thought that the informal sector is not a homogeneous phenomenon, but a very diversified one. Therefore, any attempt to study it as a whole (including the introduction of a precise broad definition) cannot be completely successful. This does not mean that any effort should be discouraged. In our view, definitions of the informal sector can vary across countries, if one bears in mind the political, economic, cultural and social differences. The differences seem to be strongest between developed and less developed countries.

2.4. **Advantages and disadvantages of the informal sector**

There is already a common consent that the informal sector constitutes a significant part of the economy as a whole. Its influence on the economy can be either positive, or negative. Many studies about the informal sector have tried to solve this dilemma. Good or bad / positive or negative? The solution to this dilemma may give an answer to another dilemma: would a reduction or expansion of this sector be beneficial to the economy as a whole? This section will deal with the history of this discussion.

The early literature and the policy climate of the 1980s especially, were dominated by the pessimistic view\textsuperscript{13} of the informal sector. According to this view, the informal sector was characterized by marginality and poverty. In addition, this sector was considered to be a source of unproductive labor and to have a residual character. However, in the 1990s, the attitudes of both the governments and the international agencies towards the informal sector were essentially reformist: they believed that the positive role played by the informal sector in the national economy could be enhanced by changes in policies at the macroeconomic level.

\textsuperscript{13} Among others, Marxist academics have in particular had this view (see Lubell, 1991).
and at the enterprise level (Lubell, 1991). The consequent research in the field has shown that the informal sector can have potential for accumulation and development. These two viewpoints (pessimistic and optimistic) have been the center of a debate on the advantages and disadvantages of the informal sector.

Several studies give different opinions on the advantages and disadvantages of the informal sector. In a broad sense, these opinions are mostly grouped into political, economic and social advantages and disadvantages. The following will briefly cover the most important studies/publications (Tanzi, 1982; Harding and Jenkins, 1989; Portes, Castells and Benton, 1989; Feige, 1989; Renooy, 1990; Kaufmann and Kaliberda, 1996; Schneider and Enste, 2000) based on their contributions to the informal sector evaluation dilemma.

2.4.1. Advantages
The main advantages mentioned in the literature are the following:

Political
• the existence of the informal sector can be used as a safety valve for public dissatisfaction and social tensions;
• informal sector activities are often tolerated or even encouraged as a way to promote political patronage.

Economic
• informal sector activities may help in maintaining the competitiveness and flexibility of production;
• informal sector activities/enterprises may bring growth if supported and encouraged;
• this sector puts downward pressure on wages in the formal labor market;
• it offers lower prices for goods and services;
• at least two-thirds of the income earned in the 'shadow economy' is immediately spent in the official economy resulting in considerable (positive) stimulating effect on the official economy, as Schneider (1998) reports about Germany and Austria;
• it generates substantial personal income;
- the informal sector is characterized by very low costs of labor;
- the low labor costs combined with the advantage of not bearing any bureaucratic cost are thought to contribute to a higher productivity of capital in this sector;
- evidence from some transition countries indicates that the particularly large decline of the official GDP that these countries experienced (especially in the beginning) was alleviated through rapid growth of the informal sector.

**Social**
- informal sector activities provide families with employment, enable them to meet their basic needs, and increase their well-being;\(^\text{14}\)
- it offers freedom and opportunities for initiative and creativity;
- it is a better alternative, even though poorly paid and unprotected, than being dependent on state benefits, or starving.

### 2.4.2. Disadvantages

Notwithstanding the positive aspects of the informal sector, research has not neglected its disadvantages:

**Political**
- due to the fact that informal economic activities are often not included in measuring the GNP, the available statistics will provide a misleading view of the state of the economy to policy-makers;
- operation of informal activities may increase corruption and political lobbying.

**Economic**
- in spite of various advantages, no development strategy and growth is expected from the informal sector;
- the informal sector (tax evasion especially) causes distortions in main economic indicators such as the unemployment rate,\(^\text{15}\) inflation rate\(^\text{16}\) and growth rate.\(^\text{17}\)

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\(^\text{14}\) Grossman (1982) argues that this positive assessment holds for the ‘informal sector’ in a planned economy as well.
the operation of informal sector activities (especially tax evasion) causes financial losses in State revenues and, ceteris paribus, generates budget deficits;

therefore, it will cause a further increase in the tax rates;

according to Frey (1989), the informal sector (especially tax evasion) is negatively related to the provision of public goods due to the falling State revenues;

its existence induces an unfair competition for those involved in the national and international formal sector;\(^\text{18}\)

if the informal sector is quite widespread in a country, it may increase the technological gap between this country and other industrialized ones;

work in the informal sector is often characterized by low productivity and low income;

according to Johnson et al (1999), economic growth will be impeded, because informal activities cannot make use of market-supporting institutions like courts of law and this may discourage investments. This has occurred in Peru, as reported by de Soto (1989).

Social

participants in the informal sector are worse off than those in the formal sector regarding their working conditions and because of the exclusion from any social benefit and social and legal security;

public and private agents will be provided with false information due to the incorrect measurement of GNP (which is mainly caused by tax evasion);

participants in the informal sector have an unfair advantage (no taxes or social security contributions) compared to participants in the formal sector.

To a large extent, studies of the informal sector in developed and less developed countries seem to share the same views on the advantages and disadvantages of the informal sector. However, studies of transition countries point out some notable differences regarding their negative assessment of the informal sector. If we refer to the communist period in these

\(^{15}\) The unemployment rate can be overstated because the individuals involved in the informal sector activities might be counted as part of the labor force, while they are officially unemployed.

\(^{18}\) Feige argues that the inflation rate is overstated as prices in the ‘informal sector’ are thought to grow at a lower rate than in the formal sector.

\(^{17}\) The real economic growth rate will be distorted due to the exclusion of the ‘informal sector’ in measuring the GNP.
countries, it appears that the party in power has attributed a negative political assessment to
the informal sector operation, because it undermines the authority of communist dictatorship
(Grossman, 1982). This opinion seems to have remained even during the transition period,
with the only difference that in the latter case 'it undermines the effective management of the
economy by the State' (Kaufmann and Kaliberda, 1996). In addition, these authors claim that
even if it is large, the informal sector is mostly a survival sector where the short-term turnover
dominates the long-term one, and where large-scale and vital investments do not take place.

2.4.3. Policy implications
The effects of the informal sector on the economy as a whole are still being debated. As a
consequence, there is much controversy about government policies vis-à-vis this sector.
Several case studies have led to very diverse arguments and suggestions. However, contrary
to the situation many years ago, academics as well as society are fully aware of its existence.
The main issue remains how to react towards it.

According to the analysts with a negative evaluation, formalization of the informal
sector is needed. The disadvantages dominate the advantages. Therefore, the informal sector
should be reduced in size. In addition, its residual and marginal character (according to the
supporters of this opinion) makes its transformation a necessity.

Nevertheless, the positive view of the role of the informal sector has increased with the
development of the literature. Even within the group of positive analysts, however, there is
much controversy about the appropriate attitude towards the informal sector. Some think that
the informal sector has its own dynamics, it promotes small business and it reduces
unemployment. Therefore, it should be supported. Others think that notwithstanding these
advantages, it should not be supported because wrong policies will be pursued, distortion of
the distribution of resources will occur and its implications in the long-run are worse than its
positive economic, social and political consequences in the short-run. In addition, as Kesner-
Skreb (1997:9) states, 'regardless of the so often and loudly praised entrepreneurial spirit of
the unofficial sector, it is incapable of taking a leading position in economic development,
which will always remain in the formal sector'. Consequently, the latter group suggests its
integration into the formal economy.

18 This disadvantage is often stressed by labor unions (see Sabel 1982).
Chapter 2

The controversy between these views is more extreme regarding the informal sector in developing and transition countries. The prevailing belief in these countries is that the negative implications dominate.

The essential difference between the significance of the informal sector in developed and less developed countries is that whereas in less developed countries the informal sector is identified with low income and little if any accumulation capacity (survival features), in developed countries there are possibilities for accumulation and incomes are often comparable to the standard in the formal sector.

To conclude, it is very important to emphasize again what Kesner-Skreb (1997:21) has asserted: 'Which measure to take and how seriously the state should choose to undertake them to prevent the unofficial economy depends primarily on the socially acceptable volume of the grey zone. Some governments are inclined to tolerate a high extent of unofficial economy in certain political and social situations in order to retain social peace. Others, again, in different social circumstances are less friendly to the unofficial sector'.

2.5. Theories related to the informal sector

Research on the informal sector is based on several theories. Even though various components of these theories have been described previously, this section will analyze them in more details. Whereas the previous section discussed descriptive theories in as much as they are related to the characteristics of the informal sector, the theories presented here are chosen because they try to explain rather than describe the informal sector phenomenon. Often they are based on empirical observations, but they try to give a view of the relationship between formal and informal activities or to explain the motives/reasons to participate in the informal sector. As with other topics discussed until now, we will maintain the structure based on the division of studies in developed and less developed countries. This structure can help to recognize potential differences between both groups of studies. Finally, due to the frequent combination of theoretical analysis and empirical evidence, many of the studies we mention cover both aspects.
2.5.1. Studies in developed countries

2.5.1.1. The relationship between the formal and informal sector

In the earliest studies of the informal sector (during 1960-1970), the dominant theory was one which considered the informal sector a separate economic domain or in other words which supported dualism. The concepts of dual economy\(^1^9\) and social marginality\(^2^0\) were already mentioned in 1953 by the 'colonial economist' Boeke. He describes the dual economy as consisting of an urban market economy (of a capitalist nature) on one hand and a rural subsistence economy (static agricultural system of production) on the other. This theory was later criticized for its descriptive rather than explanatory nature, the acceptance of economic dualism, and the assumed autonomous relationship between the formal and informal sectors instead of the one of domination and subordination (Harding and Jenkins, 1989).

Research in the following years showed the significance of the informal sector and its complete integration into the national economy. The mainstream theory of this period considered informality a reality, characterized by 'its own right, with its own rules, conditions and characteristic modes of representation' (Harding and Jenkins, 1989). Supporters of this theory reject the notions of economic dualism and social marginality. They do not see the informal sector as a set of survival activities performed in a marginal society. This theory is characterized by its explanatory power and the recognition of another relationship between the formal and informal sectors. This is a linking relationship where the informal sector is dependent on the formal sector. This dependence could be either complementary (e.g. via subcontracting activities) or competitive (e.g. unregistered business activities where labor is cheaper and prices are lower).

In a parallel way, two important theoretical approaches (mainly as subordinates of the latter theory) emerged: the so-called 'production-rationale' approach and 'illegality-based' approach. The first approach emphasizes the influence of the State in the economic cycle and distribution of resources. Conversely, the second approach emphasizes traditional economics (laissez-faire), where there is no need for State regulation or intervention. As a consequence, 'the production-rationale' approach favors State regulation of the informal sector in order to

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\(^{19}\) The concept of dual economy is conventionally known as modern against traditional; or capitalist versus non-capitalist; or industrial-urban as against agrarian-rural modes of production.

\(^{20}\) This notion means that informal activities were perceived as marginal.
integrate it into the formal economy. The 'illegality-based' approach, on the other hand, argues that the informal sector should be left free, and that the State should let the market forces rule. Despite their positive contributions, Guerguil (1988) has criticized both of them because 'neither of the two approaches performs the dual function: to establish an analytical framework and a measurable indicator'.

In his theoretical approach, Renooij (1990) models the informal sector as a simple cyclical phenomenon in which subjects undertake activities (work), which may or may not lead to transactions, from which payments may or may not result, which produce income, which again may be used in various ways. This approach yields several distinct features of the informal sector compared to the formal economy: (1) formal regulations and rules are absent; (2) there is often a higher degree of flexibility than in the formal labor market; (3) it is not the organization but the form of payment which differs compared to the formal economy; (4) these activities take place both within and outside formal contexts and they strongly interact with each-other; (5) there is no complete information; (6) this sector is highly fragmentary; (7) there is a combination of various (informal) activities because sometimes one activity alone does not produce sufficient income; (8) there is a low entrance threshold to the informal sector; (9) the price of goods and services in this economy is lower than in the formal one; (10) there is a lower capital intensity; (11) there is a lower level of productivity; (12) the informal sector relies predominantly on social/family networks, where subcontracting is its connection with the formal economy; and (13) sometimes there is an absence of channels of access to the formal activities.

An important argument concerns the effect that the formal sector has on the informal economy. In particular, the question is whether this effect is pro- or anti-cyclical. In 1991, Lubell suggested that both effects are possible. Whenever the formal economy contracts, individuals become more involved in informal sector activities for lack of alternative ways of earning a living (anti-cyclical); whereas whenever the formal economy expands, the direct and indirect demand for goods and services produced in the informal sector will require the work of more individuals in informal sector activities (pro-cyclical). Greenfield (1993) sees the development of the two sectors in a parallel way only. However, he reports that O'Higgins (1989) considers the opposite.
Recently, there is an increasing contribution from institutional economics. Institutional economists focus their attention on the relationship between the ‘rules of the game’ and economic development, considering that institutions are not neutral, but they can substantially stimulate or hinder the process of economic and overall development (Feige, 1990:990). Institutions consist of formal institutions (i.e., political and economic rules) and informal institutions (i.e., social norms and traditions). Changing merely the formal rules will produce the desired results only when the informal norms are complementary to that rule change, and enforcement is either perfect or at least consistent with the expectations of those altering the rules (North, 1997:19). Conversely, as Feige (1997:22) states, whenever formal and informal institutions clash, non-compliant behaviors proliferate, forming various underground economies. This distinction will prove to be important in chapter 6, which discusses the consequences of the results obtained in a field study about the informal sector (tax evasion) in Albania.

2.5.1.2. Tax evasion and its causes

Research continued, developing several new approaches within the framework of the mainstream theory. These typically try to explain certain aspects of the informal sector. An example is the ‘tax evasion’ approach extensively analyzed by Feige and Tanzi. According to Tanzi (1982), the main determinants of tax evasion are: (1) the perceived fairness of tax laws; (2) the attitude of tax-payers vis-à-vis their government; (3) their basic religious and cultural characteristics; (4) the expected severity of penalties imposed on the tax evaders; and (5) the ease of evading taxes.

There is a causal correlation between the ‘tax evasion’ approach and one that deals with the reliability of the nation’s information system. Feige (1989) contemplates a split up of the unobserved economy in two elements: a monetary sector which utilizes money as a medium of exchange and a non-monetary sector in which the exchange occurs through barter or its goods and services are self-consumed. Due to the unreported income (tax evasion) from both these sectors, the national accounting system is misleading. Consequently, Alford and Feige (1989) suggest that ‘information must be treated as an endogenous variable in social systems whenever there exist behavioral incentives and mechanisms to manipulate the information system’. They argue that apparent economic stagnation may partly result from the statistical
illusion or distortion (due to the exclusion of the informal sector in the conventional measures of national income).

All these ideas have been extensively discussed by Frey (1989), who refers back to two theories relevant for the informal sector, launched for the first time in earlier studies. The first theory is the theory of optimal taxation or the social-welfare maximizing approach. Its pioneers are Ramsay (1927), Allingham and Sandmo (1972), Srinivasan (1973), Singh (1973) and Kolm (1973). This theory is used to determine that tax rate which maximizes economic well-being as described by a social welfare function, taking into account the effect taxes have on the supply of labor, the production of goods and the distribution of income. The second theory is the economics of crime by Becker (1976), who studies the possibilities for controlling illegitimate activities, looking both at the supply of and demand for (i.e., the partial neglect of protecting oneself against) offenses. These two approaches are primarily concerned with the individual behavior regarding tax evasive and illegal activities.

Frey’s main criticism about the social-welfare maximizing approach is that ‘government is not an exogenous actor in the political-economic system free to pursue the social good but is dependent on other decision makers, particularly on the support of voters and interest groups’. Alternatively, he suggests another approach: the theory of democratic economic policy. According to this theory, ‘in a system of decision makers each of which pursues his own utility, the size of the official as well as that of the unobserved economy is the unintended outcome of their actions’. In other words, the informal sector activities are the consequence of self-interested decision makers.

Recent studies have attempted to analyze how the effective enforcement of tax policies or the complexity of the tax system affects individuals’ decisions to evade taxes. The micro-economic study of Schneider and Neck (1993), based on Austria and later on the Scandinavian countries, concludes that lowering only the direct tax burden is not sufficient to decrease tax evasion. In addition, a less complex tax system with a broader tax base is certainly needed.

An interesting relation between the size of the state and the level of tax evasion has been observed by Tanzi and Schuknecht (1997). They say that the two are positively correlated. They report that in 1978, ‘big’ states (the ones where the share of public expenditure is higher
than 50% of the GDP, for example Belgium, Italy, and the Netherlands) had the highest level of tax evasion, 11.1% of the GNP. ‘Medium’ states (the ones where the share of public expenditure varies between 40 to 50% of the GDP, for example Austria, Canada, France and Germany) had a medium level of tax evasion, 8.2%. Whereas ‘small’ states (the ones where the share of public expenditure in the GDP is smaller than 40%, for example Australia, Switzerland, Great Britain and the USA) had the lowest level of tax evasion, 6.2% of the GNP.

In their cross-country analyses, Johnson et al., (1998a, 1998b) and Friedman et al., (1999) argue that institutional aspects, such as the efficient enforcement of tax policies and low levels of bureaucracy and corruption, affect the taxpayers’ attitudes towards taxes more than the tax burden per se. Moreover, as suggested by the institutional approach, low tax morality, lack of confidence in public institutions and non-provision of public goods have a strong impact on the (non)compliant behavior of taxpayers. For a detailed discussion on the effects of the shadow economy (tax evasion) on the official economy, see Schneider and Enste (2000:22-24).

2.5.1.3. Motives and causes of informalization

The existence of an informal sector and its persistence over time has been explained by a variety of reasons. Public attention was drawn to the underground economy during World War II when higher tax rates, price controls, and rationing programs provided incentives for firms and individuals to participate in various ‘black market’ activities (Feige, 1989). The study of these elements is considered to be very important, in order to understand this phenomenon more in depth and to reach a scientific conclusion regarding its overall significance.

The majority of analysts have agreed, to a large extent, that one of the foremost causes of the development and tenacity of the informal sector is economic recession. As a consequence of stagnation, a lot of unpleasant economic phenomena appear, such as unemployment and depreciation of capital, which in turn influence the informal activities. Some of the primary

\[21\] Sandmo (1981) develops a model based on this theory in order to determine the optimal size of the unobserved sector for policy purposes.
reasons to participate in the underground economy mentioned in the early literature are: (1) to evade taxes; (2) to avoid losing government benefits; (3) to circumvent regulations and licensing requirements; (4) a reaction by both firms and individual workers to labor unions; and (5) the impact of international competition.

In broader terms, the motives for participation can be economic and non-economic. The economic reasons are related to unemployment and an inflexible formal labor market; the declining real price of capital; and the high cost of formal production. The non-economic motives are related to a greater flexibility and greater satisfaction in work; a complete use of their professional qualifications; and the increased leisure time. A very important element, which motivates the participation in the informal sector, seems to be the role of the State. Beyond economic considerations, State-related variables are decisive in creating a climate suitable for the expansion of the informal sector (Gershuny 1979). These State-related variables and other motives are discussed by Renooy (1990) from the perspective of behavioral economics. He claims that there are two groups of factors which determine the decision to become active in the informal sector, specifically, the 'structural' and 'opportunity' factors. The structural factors consist of financial pressure; socio-psychological pressure; and institutional constraints. The opportunity factors, which imply free choice, consist of individual background; skills; education; contacts and living situation, or non-individual components such as environment; cultural tradition; values and standards; and geographical factors. The author suggests that these 'opportunity' factors explain why different sorts of informal economies exist. The individual free choice affects the decision on tax payments based on a combination of inadequate information and a lack of any trust in the way taxes are spent. In an atmosphere in which the government loses the trust of the population, in which people no longer feel that government supports them, a step into the twilight economy will be taken much more lightly (Renooy, 1990). The questionnaire of our field survey in Albania included some attitudinal questions, which try to cover some of these determinants. Their empirical analysis is presented in chapter 6.

Besides the evasion of taxes, another frequently mentioned reason for participation in the informal sector is the governmental over-regulation of the market sector, not only via

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22 If incomes exceed a specific level then individuals may no longer receive all or part of their benefits.
23 This implies the move to underground activities due to the competition with cheaper Third World imports.
24 Pressure here means 'pressed by circumstances'.
taxes but also through, for example, legislation related to labor conditions, quality regulations, and production limits. This over-regulation increases the transaction costs of participation in the formal economy, so that it becomes relatively more appealing to switch to the informal sector. Johnson et al, (1997 and 1998b) find empirical evidence that more regulation indeed means a larger informal sector. Other motives related to the labor market are the increased number of unemployed people, the reduction in working hours, early retirements, and the supportive social welfare systems. Each of them provides incentives to individuals to search for new job opportunities, which are mostly available in the informal sector.

2.5.2. Studies in developing and transition countries

2.5.2.1. The relationship between the formal and informal sector

The early literature on the informal sector mostly focused on the Third World countries and has, wittingly or not, assumed that as a social type such sectors are not to be expected in advanced industrialized countries (Feige 1979; Gutmann 1977; Tanzi 1982). However, research has shown that the informal sector not only exists, but is often a very problematic phenomenon in developed countries. As a matter of fact, the theories for developed countries, mentioned above, hold to a large extent for less developed countries as well. Therefore, we will be brief in mentioning some theoretical developments specific to the latter.

Early studies of the informal sector in developing countries consider the participants of informal activities as a ‘reserve army’ of labor, who mainly survive at low subsistence levels. For example, Swaminathan (1991) recognizes that the primary reason to start with research on the informal sector in developing countries was related to the problems of mass poverty and unemployment, which has not always been the case in developed countries. Furthermore, besides the common reasons – mentioned in section 2.5.1 – for small-scale enterprises to go underground, he argues that historical circumstances, like poverty and survival needs, are also important for explaining the occurrence of an informal sector in a less developed country.

We have already mentioned that the informal sector was present even in centrally planned economies.25 Theories describing informal activities in these economies are expected to have particular features. However, although the economic regime is substantially different

25 According to Sampson (1987), the primary element of the ‘informal sector’ in these countries was private agriculture.
than in Western economies, the informal sector acts as a safety valve for political discontent in planned economies as well. In addition, while in the West individuals earn incomes that are taxed, in socialist economies the resources are withheld at the outset by the overall imposition of scarcity as dictated by the central plan (Feige, 1989). Grossman (1982) has contributed significantly in providing a lot of evidence about the informal activities in these economies, especially for the USSR. His research has shown the following: (a) the demand for informal income and the supply of informal goods and services inevitably reinforced each other, and (b) exchange of favors in the form of access to goods or services was a salient feature of the Soviet informal sector. More specifically, some forms of informalization were: private lucrative use of socialist property; theft from the state and cooperatives; bribe-taking by officials; and bribe-giving, in money or natura. He gives a very interesting explanation of this phenomenon in the form of a circle, which starts with the state compensating for its loss through theft by paying lower wages. The individual in turn will consider this as an implicit justification to steal from the state - especially in a situation of pervasive goods shortages - and the circle closes. He concludes that these characteristics might be similar in other communist countries of Eastern Europe, 'since both the underlying causes of the second economy and its symptoms and manifestations are essentially the same there as in the USSR, despite country differences'. Further theoretical and empirical evidences about the informal sector in former socialist countries are given by Kornai (1993), Schneider (1997) and Lacko (1998). They observe that the informal sector activities in these countries, especially in the last period before transition, were much more wide-spread than in an 'average' market economy. This contradicts the common view that these countries experienced a relatively small informal sector, especially compared to developed countries.

Another typical feature of the informal sector in centrally planned economies is the existence of both the 'second' and the 'third' economies (Ellman 1989). The 'second' economy consisted of hidden transactions of goods or services that were privately produced. The 'third' economy consisted of hidden activities by or within large enterprises, which were normally tolerated by the party officials in order to achieve the goals of the central plan.

Long after the early studies of centrally planned economies (e.g., by Grossman, 1982), the informal activities were again a subject of study, but this time during the transition period

26 At any rate, one is often reassured that "everybody does it anyway".
these countries were going through. In the literature, the following characteristics appear to be relatively specific to the informal sector in transition countries.

During the transition period, the ‘second’ economy has been legalized (i.e., production and exchange of private goods), although this does not exclude the possibility that some of the new private enterprises are operating in the informal sector (see below). The ‘third’ economy has remained the same: informal activities take place within large enterprises mostly (Dolgopiatova, 1998). Therefore, both the ‘second’ and the ‘third’ economies operate formally and informally during the transformation of post-socialist countries.

Considering the pro- or anti-cyclical character of the relationship between the formal and informal sector, an interesting research run by Arvay and Vertes (1995) for Hungary (covering the socialist as well as the transition period, 1980-1993) concludes the following. There is a pro-cyclical relationship during the socialist period (before 1989) and an anti-cyclical relationship during the transition period (1989-1993).

Some researchers argue that the informal sector in transition countries is characterized by almost zero entry and exit costs. This argument, however, has been criticized because research has shown that the informal sector does have some entry and exit costs. The extensive use of barter is another typical piece of evidence from some of these countries, especially Russia. Ellman (2000) summarizes several reasons for the growth of barter, such as criminalisation, tax evasion, a failed privatization strategy, a survival strategy for insolvent and loss-making firms, suppressed inflation or contagion, or some combination of these factors. In addition, the new small formal sector businesses in some of these countries hardly show any trend to expand and grow (e.g. in Russia). Some of the reasons put forward are: to avoid the attention of tax authorities and criminal organizations and often to delay paying wages to the workers. Finally, some argue that the rapid growth of the informal sector from a relatively low base has been a notable feature of some transition economies.

27 Note that this phenomenon is not observed in other countries.
28 For more, see Kaufmann and Kaliberda (1996).
29 One example is related to the existing network in an informal market, which increases the entry cost if a person is not part of the network. For more, see Fields (1990).
30 For more details, see Gaddy and Ickes (1998).
31 It has been argued that sometimes they do not want to attract the attention of potential investors as well, because these might see the business as a potential takeover target (for further comments, see Gaddy and Ickes, 1998).
32 For more details, see Kaufmann and Kaliberda (1996) and Commander and Tolstopiatenko (1997).
The expansion of the informal sector is also related to the large share of public expenditure in the GDP of these countries. This was more the case in the early years of their transition. In addition, less developed countries face a higher level of tax evasion due to their weakened fiscal authority, which in turn shifts a greater burden of revenue collection to monetary policy (Feige, 1990).

Several further attempts have been made to analyze the operation of the informal sector through modeling and other theoretical and empirical methods, which have further enriched the theories of the informal sector in transition countries. Some of these methods will be discussed in section 2.6. However, a more insightful research about the informal sector activities in these countries is needed.

Finally, the recent institutional approach is particularly emphasized in the case of less developed countries, where the incompatibility between the formal and informal institutions is more evident than in the developed countries. Consequently, the occurrence of informal activities in the former countries is expected to be more dominant than in the latter.

2.5.2.2. Motives and causes of informalization

Informal activities have their own reasons for existence and growth in developing and transition countries. Nevertheless, the majority of reasons and motives converge for developed and less developed countries. There are a few specific reasons which diverge, however.

- developing countries
First of all, the low rate of industrialization and productivity, and the presence of surplus labor are listed as principal reasons why a dualistic system arose in the cities of the third world (Breman, 1980). In addition, it is accepted that due to the old economic mechanism (low technology and intensive use of cheap unskilled and semi-skilled labor) that these countries have, informal activities emerge and grow quite rapidly. This is basically one of the reasons why the informal sector in less developed countries is considered to be a sector for survival.

It was emphasized above that stagnation can have a big impact on the informalization of the labor market. However, some argue that a flourishing economy can effect participation in

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the informal activities as well. This phenomenon was observed during the economic boom period of these countries.

- **former socialist countries**

Research about the informal sector under central planning recognizes some other basic motives of informalization, such as: the presence of common socialist property, which is broadly regarded as 'up for grabs'; the constant consumer shortages; the universal price controls, physical allocation of goods, and other sorts of strict official regulations; the outright banning of a wide range of consumer articles and services; the bureaucratic inadequacies; the corrupted authorities; the political dissatisfaction; and the contrast between actual life and that predicted by the official ideology.

- **transition countries**

Regarding transition countries, the distinctive reasons of informalization are mainly related to the political, economic and social institutional causes of their transformation from centrally planned into free market economies. They involve: insufficient economic development (e.g., Kaufmann and Kaliberda, 1996 mention the low degree of economic liberalization and macroeconomic instability); a high tax burden and a complicated tax system; a weak and complex legal and institutional framework (which is mainly due to the gap between the destruction of old institutions and the construction of new ones); inefficient enforcement mechanisms; a high level of corruption and bureaucratic incompetence among the government agents; the general lack of confidence in state institutions; the *laissez passer* approach towards the informal sector (i.e., the tolerance and insufficient control by the government); civil wars in some of these countries; and finally, the 'path dependency' (i.e., the conflict between the established economic and social norms in the past and the reaction to a new reality in the present).

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34 Fortuna and Prates (1989) observe that the prospering period of export of manufactures entailed high levels of benefit for entrepreneurs, use of advanced technology, and growth in the scale of production. In addition, it fostered a process of informalization disguised as small independent entrepreneurship.

35 For more details, see Grossman (1982).

36 For example, those pertaining to Western youth culture, religion, some forms of minority nationalism, and pornography.

37 In particular, macroeconomic instability seems to have stronger effects regarding currency substitution, capital flight, and barter transactions.
2.5.3. Summary
There is a variety of theories attempting to explain informal economic activities. Deficiencies, and therefore criticism, are recognized over time, consequently resulting in their improvement. The basic features of these theories hold for all countries, developed and less developed.

Differences are observed, however. They are the result of different political, economic, social and institutional features characterizing these countries. The basic difference is related to the level of development. While the informal sector in developed countries is often characterized by technological dynamism (technological innovation and accumulation) of small-scale enterprises, informal activities in less developed countries are identified by low income, low technology and survival mechanisms.

Furthermore, the informal sector in former socialist countries has shown specific characteristics, which is basically the result of a completely different institutional setting. Partly as a consequence of this, but also of the difficult transitional period towards market economies, these countries appear to develop some distinctive features of the informal sector.

Finally, the relationship between formal and informal institutions has been recently recognized as an important reason of the persistence of the informal sector in less developed countries. This relationship can be a cause of informalization if these two types of institutions are contradictory and inconsistent, which is strongly the case in less developed countries.

2.6. Empirical studies
Since the informal sector phenomenon was first accepted and broadly investigated, empirical contributions have increased substantially. This empirical work has used various methods to measure the informal sector, depending on the way in which this sector is defined. Besides the difficulties coming from terminological confusion, inconsistency in definitions, and distinct measuring methods, 'the irregular and obscure conditions make it difficult for the researcher to collect data on the informal sector' (Breman, 1980). Nevertheless, many attempts have been made, and this section summarizes the most important ones.

The empirical analysis of the informal sector in developed and less developed countries do not differ much. Most of the following methods/approaches are applicable to every country. Therefore, the distinction across the two groups of countries will not be very sharp.
2.6.1. Studies in developed countries

Two research approaches are distinguished in the literature: the direct and indirect approaches.

- **The indirect approach**
  
The indirect approach focuses on the study of already available statistics. The earliest and the most frequently used method is the *currency demand approach*, which was first applied by Cagan (1958) to obtain a rough quantitative measure of the size of unreported income in the United States during the period 1919-1955. This method implies that any significant increase in monetary notes in circulation — in other words, any increased demand for cash — corresponds to an increase in economic activity in the informal market. Henry (1976) used this method to measure the informal sector in the United States, during the period 1969-1970. Indeed, there was an increase in $50 and $100 notes in the US, which was explained by Henry in terms of an expansion in profit-oriented crime and tax evasion. Many researchers have applied this method in various countries. However, several of them do not relate the increase of notes in circulation to the increased informal sector, but instead to the price effect in currency holdings or the declining value of money.\(^3^8\)\(^\text{39}\)\(^4^0\) More objections to the monetary method to quantify informal activities are given by Gutmann (1977), and later by Macafee (1980), Tanzi (1982), Feige (1986) and Thomas (1986, 1992, 1999).

As a response to this criticism, attempts were made to develop the currency demand approach into a more accurate method to measure the informal sector. According to Gutmann (1977), it is the increase in the ratio of currency to checkable deposits that indicates an increased informal activity (taking into account that currency is the sole medium of exchange in the informal sector). However, Garcia (1978) and Feige (1996) attribute this increase more to a decrease in demand deposits than to the expansion of informal activities in the United States especially. Tanzi’s econometric estimations in 1980 and 1983 tried to quantify the shadow economy of the United States for the period 1929-1980. He estimates a currency demand function, assuming that cash payments dominate in the hidden economy, therefore an

\(^{38}\) Boyle (1984) found evidence of this by using the same method to measure the informal activities in the Republic of Ireland.

\(^{39}\) This is Tucker’s (1982) evidence from his study of the ‘informal sector’ in Australia.

\(^{40}\) Another possible explanation of the increase in monetary notes in circulation is the increased use of cash dollars outside the United States.
increase of this economy will imply an increase of the demand for currency. The criticism of his method has been constructively used by the succeeding research, based on the currency demand approach.  

Feige (1979, 1989 and 1996) introduced the so-called transactions-ratio method, which hypothesizes that 'activity in the underground economy is likely to be recorded in measures of total transactions but excluded from recorded income'. His intention was to measure the unrecorded GNP of the United States. In 1989, he stated that 'the two most widely used valuation methods are opportunity cost and market costs': (1) the opportunity cost approach attempts to measure the value of lost market income that results from production activities at home; whereas (2) the market cost approach values household production activities at corresponding market wage rates that would be paid if outside workers were hired to perform the productive activities. The deficiencies of this method are basically related to its assumptions, namely 'the constant ratio of transactions over time' and 'the existence of no shadow economy in the base year'. A recent overview of this method is covered in Thomas (1999) and Giles (1999a).

There have been efforts to assess the informal economic activities by estimating the size of the unregistered labor force. The method is called the discrepancy between the official and actual labor force. Assuming a constant actual labor force participation, if the comparison between the official and this labor force shows a decreasing official rate of labor participation, the latter is attributed to an increased informal sector. This method has been used by Contini (1981-1982) for Italy and Langfeldt (1984) for Germany. The weaknesses of this method are discussed by Schneider and Enste (2000).

Finally, in the framework of attempts to quantify informal labor activities indirectly, Portes and Sassen-Koob (1987) have used small business activities as a proxy for informal economic activities.

- The direct approach

The direct approach involves the use of samples. This can take place either by using surveys, or official responses for tax purposes (tax auditing), or experimental data.  

41 For further insights, see Thomas (1999) and Bhattacharyya (1999).
42 The latter two are mostly used to estimate tax evasion, hence they will be discussed in the following subsection about tax evasion.
one of many researchers using the direct approach applying the random sample method to quantify particular kinds of informal economic activity. Several other researchers have provided empirical evidence based on more detailed in-depth interviews with a selected sample of households. This method is considered important in quantifying the informal labor market. Another form of the sample approach is the so-called time-budget survey, which gathers detailed evidence from people, using a diary approach, to keep track of 'the changing pattern of their economic and non-economic activities outside of the formal economy' (Gershuny and Miles, 1985). In addition, Harding and Jenkins (1989) acknowledge a so-called 'nominative-technique', which implies that a 'shadow sample' of those having a particular attribute is ascertained by asking respondents about the activities of their relatives and friends. Particular conditions, such as detailed pre-testing, should be satisfied however, in order to apply this method.

Besides the indirect approach, the irregular labor market is estimated by using a direct approach as well. For example, Frey and Pommerehne (1982) have used the direct approach by interviewing a representative sample of the population regarding their participation as a buyer or seller in the market for irregular labor services. They see the advantage of this method in the fact that 'both monetary and bartering income-creating activities are captured'.

The sample method is mainly criticized regarding the potential respondent jeopardy. Lee (1985) has suggested two ways to minimize this jeopardy, basically by dealing with the respondent in more sensitive ways. For a recent discussion on the advantages and disadvantages of this method, see Mogensen et al., (1995).

Some researchers have attempted to combine the direct and indirect approaches. For example, Portes, Castells and Benton (1989) introduce a multi-country comparative study based on a methodological approach, which combines a 'horizontal' method with a 'vertical' one. The former attempts to provide quantitative estimates of the relative weight of informal production and employment in each city, whereas the later attempts to trace the articulation between formal and informal activities in selected sectors of the urban economy. They accomplish the 'horizontal' method through field surveys or re-analysis of available statistics/reports (indirect

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43 This deficiency is related to the respondents' impression of being threatened by questions, during the interview, with possible unreliable responses as a consequence.

44 For more details, see Lee (1985).
Chapter 2

approach), and the ‘vertical’ method through direct observation and in-depth interviews (direct approach). Isachsen and Strom (1989) call this combination a micro- and macro-approach. The micro-approach is based on a survey study related to unreported income from work (direct approach), whereas the macro-study focuses on the development of the stock of currency (indirect approach). It is argued that due to the combination of both approaches (direct and indirect), the statistical errors and distortions can be reduced.45

2.6.2. Tax evasion

Tax evasion has been studied using both approaches. The indirect approach uses the income/expenditure discrepancy method, which is based on discrepancies between either national or individual income and expenditure data. It assumes that while the concealment of true income may be possible, expenditure will be reported truthfully. The discrepancy based on national statistics was initially studied by Park (1979) for the United States and Petersen (1982) for Germany. The discrepancy based on individual data was used by Hansson (1989) to estimate tax evasion in various years. He studied the discrepancy between households’ total expenditures on consumption, savings, and taxes, and total income estimated from income reported on tax returns. There are positive and negative assessments of this method. Mattera (1985) stands on the positive side because ‘the reported income-reported expenditure discrepancy measures are more convincing than the currency-based techniques, inasmuch as they are related to more solid data (expenditures figures) than the latter’s dependence upon rates of circulation of money’. Conversely, Frey and Pommerehne (1982) mention three shortcomings of the discrepancy approach: (1) there are errors in both estimates of aggregate income; (2) there are errors due to differences in the statistical coverage; and (3) income not captured by tax authorities may not appear in the national income data either.

A method which is more similar to the indirect approach than to the direct one is the soft modeling method. Frey and Pommerehne (1982) launched this method47 in their comparative study of a number of industrialized (OECD) countries, where they expected to find a correlation between levels of taxation and the estimated size of the country’s ‘informal

45 For further details, see Broesterhuizen (1989).
46 The discrepancy method measures the net effect of the unobserved activity when one procedure for measuring a particular form of unobserved activity is believed to be relatively free of biases induced by that activity, while another procedure is known to be affected by it.
47 This method was later developed by Frey and Weck-Hannemann (1984) under the name 'the model approach'.
sectors'. The model- or the soft modeling- approach takes account of multiple causes of the existence and growth of the informal sector and its multiple effects over time as well. It is based on the statistical theory of unobserved variables, where the informal sector is quantified as an unobserved variable. A factor-analytic approach known as the (DY)MIMIC (dynamic multiple-indicators multiple-causes) model is used to measure this unobserved variable. Taking into account the levels of taxation and legal regulation, the countries’ ranking based on the size of the informal sector is: the Netherlands, Germany, France and United Kingdom. Switzerland, known for its comparatively high levels of taxation, seemed to have a comparatively small unofficial economy. Contrary to ‘common opinion’, Italy appeared to have a very small unofficial economy. Due to this ‘inconsistency’ in the empirical results, the authors distinguished several important factors to understand the regional differences in analyzing the informal market: (a) labor-market conditions; (b) the economic climate; (c) culture and values; (d) the organization and structure of legal and administrative frameworks; and (e) the power and nature of the State. Considering these elements, they have attempted to correct this inconsistency later. However, the main criticism of this approach was made by Helberger and Knepe1 (1988).

The direct method of sample surveys is frequently used to study tax evasion (e.g., Isachsen and Strom, 1985). For example, individual responses for tax purposes have been extensively used to estimate tax evasion. Since 1963, the Internal Revenue Service (IRS) in the United States operates under a Taxpayer Compliance Measurement Program (TCMP), through which it rigorously examines the tax returns of a randomly selected sample of about 50,000 taxpayers. Therewith, the tax returns of these people are interconnected with supplementary information reports submitted by businesses and individuals. The discrepancy between the self-declared income and the randomly selected checks will give an indication of the taxable income evaded. However, it is argued that the unreported transactions, either by the vendor or by the purchaser of goods and services, will not be examined by this method and this is considered to be one of its failures.

‘Sample surveys’ is one of the direct methods used in this thesis to study tax evasive behavior of households in Albania. The methodological procedure used to conduct the survey is explained in chapter 5, followed by an analytical and empirical study of the results in chapter 6.
Recently, another method (as part of the direct approach) is becoming more popular: laboratory experiments. Whereas other methods (direct and indirect) are used to analyze almost every aspect of the informal sector, the experimental method is mostly applied to study tax evasion only. The first experimental study on tax evasion was a collaboration of social psychologists and economists (Friedland, Maital and Rutenberg, 1978). The basic design of these type of experiments is described in a survey by Alm (1991). It is simple: participants declare tax based on an income determined in the experiment. They are provided with information regarding tax rates, audit probabilities and fines for cheating (underreporting income). The advantage of experiments is the opportunity to control the situation in the laboratory, or in other words, the opportunity to control external factors, which might otherwise affect the circumstances governing behavior. In addition, laboratory experiments allow one to study individual behavior directly, in the controlled environment. A disadvantage is that the laboratory setting might not be applicable to the real world setting it aims at studying. However, a combination of properly designed experiments with 'real world' data may yield successful results. For further discussion of the role of experiments in studying tax evasion, see Webley et al., 1991.

'Experiments' is the other direct method applied in this thesis to study tax evasive behavior in Albania and the Netherlands, as shown in chapter 4.

2.6.3. Studies in less developed countries

The empirical methods described so far in the case of developed countries are mostly applied to measure informal activities in less developed countries as well.\(^\text{48}\) The direct method is used more often in transition countries (even during their socialist system). However, there are also efforts to measure it using indirect method. For example, Kaufmann and Kaliberda (1996) have used the macro-electrical approach or the physical input method.\(^\text{49}\) They argue that ‘by having a proxy measurement for the overall economy and subtracting it from estimates of official GDP, an estimate of unofficial GDP can be derived’, where the electric-power consumption is regarded as the best variable/indicator to measure the overall economic

\(^\text{48}\) One exception is the application of the experimental method, whose short history so far estimates tax evasive behavior only in developed countries.

\(^\text{49}\) This method was initially used by Lizzeri (1979) and Del Boca and Forte (1982), as reported by Schneider and Enste (2000).
activity in an economy. They conduct a cross-country study among the Central and Eastern European (CEE) countries by using this method. This method is considered to be simple and helpful, but some aspects of it are treated with reserve even by the authors themselves.

Lacko (2000) was also skeptical about this method, therefore she developed it into the so-called household electricity approach. This approach avoids the inconsistency of the previous approach.\(^{50}\) The main assumption of the household electricity approach is that a part of the household consumption of electricity is used in the hidden economy (in other words, the hidden economy is present in all sectors of the economy, including households). This method is based on an econometric model and it attempts to determine the share of the hidden economy in 19 OECD countries. After some modifications, the same method is applied to a few transition countries.

In addition, the national income/expenditure discrepancy method has been applied by Yoo and Huyn (1998) to measure the shadow economy in Russia and Hungary.

2.6.4. Discussion and empirical results

Two main approaches have been discussed to estimate/quantify informal economic activities: the indirect and direct approach. Several methods have been employed as components of these approaches, such as a number of monetary methods, a number of discrepancy methods to measure unreported income and unregistered labor, small or large survey/sample methods, and experimental analysis. A summarized version of all these methods is presented in table 2.4 below.

Any measurement of the unofficial economy is subject to substantial margins of error (Kaufmann and Kaliberda, 1996). Therefore, given the difficulties inherent in any effort to quantify the unobserved sector, the various approaches to measurement are best viewed as complementary, yielding insights into different aspects of the issue (Feige, 1989). Every new method has gone through filters of evaluation and criticism over time and across countries.

\(^{50}\) According to Lacko (2000), 'it is the structural differences and their rapid changes that has had a dominant impact on total electricity consumption in these countries and its relation to the registered GDP in the course of transition, and not the hidden economy'.
Table 2.4: Research methods for estimating the informal sector

<table>
<thead>
<tr>
<th>INDIRECT APPROACH</th>
<th>DIRECT APPROACH</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency Demand approach</td>
<td>Sample Surveys</td>
</tr>
<tr>
<td>Transactions-Ratio method</td>
<td>Tax Auditing</td>
</tr>
<tr>
<td>Official-Actual Labor Force discrepancy</td>
<td>Experimental Analysis</td>
</tr>
<tr>
<td>National Income-Expenditure discrepancy</td>
<td></td>
</tr>
<tr>
<td>Individual Income-Expenditure discrepancy</td>
<td></td>
</tr>
<tr>
<td>MODELS</td>
<td></td>
</tr>
<tr>
<td>Soft-Modeling approach (MIMIC model)</td>
<td></td>
</tr>
<tr>
<td>Household Electricity Consumption:</td>
<td></td>
</tr>
<tr>
<td>- The Lacko approach</td>
<td></td>
</tr>
<tr>
<td>- The Kaufmann &amp; Kaliberda approach</td>
<td></td>
</tr>
</tbody>
</table>

The indirect approach has been criticized most because, contrary to the direct approach, it does not give specific and inside information about the participants and location of the informal sector. Especially, the monetary-ratio method has been strongly criticized. ‘It has always made me think of the person who wanted to measure a girl’s height by the length of her skirt’ (Tanzi, 1982). Nevertheless, there have been efforts to improve the quality of estimations using indirect methods.

Table 2.5 below summarizes the estimated share of the shadow economy in developed countries. The data show the lowest, average and highest estimated share of the shadow economy from three selected methods. For 1978, there is a reasonable consistency (comparing the soft model approach and currency demand approach) regarding the highest estimated share. The same occurs but for the lowest share (comparing the currency demand approach in 1989-90 and the household electricity approach in 1990). Furthermore, the size of the shadow economy in developed countries seems to be increasing over the years, on the basis of all methods.

Several researchers have implemented these methods in less developed countries as well. The estimated figures are summarized in table 2.6. It appears that the soft model approach and the currency demand approach are mainly used to estimate the shadow economy in developing countries, whereas the household electricity approach has been applied more in the case of transition countries. The comparison of results of the currency demand approach and the household electricity approach for developing countries in the period 1989-90, shows

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51 The estimations are based on the definition of the shadow economy as all economic activities which contribute to the officially calculated GNP, but are currently unregistered.
a large inconsistency, especially for the highest estimated share. This could be explained by the limited number of observations and/or currency substitution in the case of the currency demand approach. The consistency check is not possible for transition countries, because the figures refer to different periods. However, we can say that the available estimates suggest that the share of the shadow economy has increased over the years in both, developing and transition countries. In spite of the inconsistencies across methods, tables 2.5 and 2.6 can be used to compare the two groups of countries. As expected, this yields the conclusion that the share of the shadow economy is larger in less developed than in developed countries.

2.7. Conclusion

Starting from complete neglect, the phenomenon of informal economic activity has grown to be a subject of study by many researchers, both governmental and non-governmental. In our view, this research has consisted of three important domains: definition, measurement and significance of the informal sector.

In the light of the many and varied aspects of the informal sector and consequently the variety of criteria describing each of them, several definitions have emerged. Many researchers have considered this a disadvantage. Therefore, numerous unsuccessful efforts have been made to formulate a unique definition. In our view, there is no need for a universal definition. As long as researchers share a definition for each separate aspect/activity of the informal sector, there will be, first, a basis of comparison between studies (for each activity) and second, the sum of all activities will provide a picture of the informal sector as a whole. A comparison between studies of the informal sector in developed countries and studies in less developed countries has shown that the basic divergence is related to the ‘survival’ criterion. Consequently, studies in developed countries show that the informal sector offers possibilities for accumulation, whereas research in less developed countries provides evidence that survival is the main characteristic of the informal sector there. As Pardo (1995) observes, survival always ‘legitimizes’ law avoidance in extreme situations, where a conflict between morality and individual rationality emerges: actors justify their actions by lack of choice. This could be an additional reason why the size of the informal sector in less developed countries is bigger than in developed countries.
Table 2.5: A summary of estimated results of the share of the shadow economy in developed countries (% of the official GDP)

<table>
<thead>
<tr>
<th>Countries</th>
<th>Soft model approach</th>
<th>Currency demand approach</th>
<th>Household electricity approach</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1978</td>
<td>Average 1989-90</td>
<td>Average 1990-93</td>
</tr>
<tr>
<td></td>
<td>low. aver. high.</td>
<td>low. aver. high.</td>
<td>low. aver. high.</td>
</tr>
<tr>
<td>Developed</td>
<td>1978</td>
<td>Average 1990-93</td>
<td>Average 1990-93</td>
</tr>
<tr>
<td></td>
<td>low. aver. high.</td>
<td>low. aver. high.</td>
<td>low. aver. high.</td>
</tr>
<tr>
<td>Swit.</td>
<td>4.3</td>
<td>3.7</td>
<td>5.1</td>
</tr>
<tr>
<td>Swed.</td>
<td>8.8</td>
<td>10.9</td>
<td>14.0</td>
</tr>
<tr>
<td>USA</td>
<td>13.2</td>
<td>18.0</td>
<td>22.8</td>
</tr>
<tr>
<td>Spain</td>
<td>3.7</td>
<td>10.9</td>
<td>14.0</td>
</tr>
<tr>
<td>Austria</td>
<td>5.1</td>
<td>14.0</td>
<td>22.8</td>
</tr>
<tr>
<td>Italy</td>
<td>6.1</td>
<td>15.1</td>
<td>24.0</td>
</tr>
<tr>
<td>Norw.</td>
<td>9.3</td>
<td>16.1</td>
<td>22.9</td>
</tr>
<tr>
<td>Spain</td>
<td>5.1</td>
<td>14.0</td>
<td>22.8</td>
</tr>
</tbody>
</table>

Sources: The figures for the soft model approach and currency demand approach in 1978, and household electricity approach in 1990 are taken from Lacko (2000). The figures for the currency demand approach during 1989-90 and 1990-93 are taken from Schneider and Enste (2000).

Table 2.6: A summary of estimated results of the share of the shadow economy in less developed countries (% of the official GDP)

<table>
<thead>
<tr>
<th>Countries</th>
<th>Soft model approach</th>
<th>Currency demand approach</th>
<th>Household electricity approach</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Average 1990-93</td>
<td>Average 1989-90</td>
<td>Average 1990-93</td>
</tr>
<tr>
<td></td>
<td>low. aver. high.</td>
<td>low. aver. high.</td>
<td>low. aver. high.</td>
</tr>
<tr>
<td>Developing</td>
<td>16.5</td>
<td>9.0</td>
<td>13.0</td>
</tr>
<tr>
<td>Taiwan</td>
<td>41.1</td>
<td>33.0</td>
<td>44.5</td>
</tr>
<tr>
<td>Boliv.</td>
<td>65.6</td>
<td>13.0</td>
<td>76.0</td>
</tr>
<tr>
<td>South Africa</td>
<td>21.0</td>
<td>44.5</td>
<td>Niger</td>
</tr>
<tr>
<td>Mexico</td>
<td>33.0</td>
<td>27.2</td>
<td>23.3</td>
</tr>
<tr>
<td>Hong K &amp; Singp.</td>
<td>13.0</td>
<td>13.0</td>
<td>23.3</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>20.1</td>
<td>20.1</td>
<td>37.1</td>
</tr>
<tr>
<td>Poland</td>
<td>27.2</td>
<td>27.2</td>
<td>50.8</td>
</tr>
<tr>
<td>Uzbek</td>
<td>37.1</td>
<td>27.2</td>
<td>42.7</td>
</tr>
<tr>
<td>Georg</td>
<td>50.8</td>
<td>37.1</td>
<td>62.1</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>23.2</td>
<td>42.7</td>
<td>62.1</td>
</tr>
</tbody>
</table>

Sources: All the figures for developing countries are taken from Schneider and Enste (2000). The figures for transition countries are taken from Lacko (2000). Note: The soft model approach and the currency demand approach have very few observations for the developing countries.
Another important debate is related to the significance of the informal sector, and therefore to the best reaction towards it. Opinions are split between the negative and positive assessment. The first sees the informal sector as negligible, with a residual and marginal nature. The second assessment considers the informal sector as a dynamic phenomenon, which might have a significant impact in the economy. Considering its negative long-run implications, they suggest its (gradual) integration into the formal economy. These opinions hold mostly for the informal sector in developing and transition countries and sometimes for developed countries. In developing and transition countries, in view of the general poverty, low technology and level of development, informal activities are often considered as an economic, political and social safety valve for public discontent. Nevertheless, transformation in the long run is considered a necessity. The essential difference observed between the informal sector in developed and less developed countries is that the informal sector in developed countries may show possibilities for growth and a comparable standard of income with the formal sector. On the other hand, the informal sector in less developed countries is identified with low income and little if any accumulation capacity.

All in all, the State's attitude towards the informal sector has basically had the following patterns over the years: neglect → either tolerance or conflict (reduction) → integration into the formal economy. The majority of developed countries have reached the final stage of this pattern, whereas most of less developed countries are still either in the second or between the second and the third stage.

Efforts have been made to establish theories, which aim at explaining the informal sector phenomenon. Some of them have been only descriptive, some others have tried to explain informal economic activities. The basic features of these theories hold for all countries, developed and less developed. Differences, which are mainly related to different political, economic, social and institutional characteristics of these countries, are observed however. The main difference is related to the level of development. Accordingly, technological dynamism (technological innovation and accumulation) characterizes, to a large extent, the informal sector in developed countries, while low technology and survival mechanisms characterize the informal sector in less developed countries. A recent major difference is recognized by the new institutional approach which 'aims to redirect policy attention toward the restructuring of indigenous institutions that play a vital role in the
development process’ (Feige, 1990:1000). A better understanding of why the informal sector exists and what is its relationship to the formal sector needs further research, however. In order to do this, one should bear in mind what Harding and Jenkins (1989:4) have emphasized, that ‘each economic system (developed, developing and transition) requires correspondingly different analytical frameworks if we are to understand the way they work and the relationship between formality and informality in each context’.

The third important domain is related to the measurement of informal sector activities. The literature discusses two main approaches to quantify the informal sector: the direct and indirect approach. The indirect approach focuses on the study of already available statistics, while the direct approach operates using sample surveys. These two main approaches consist of several other methods, which are used to estimate diverse activities of the informal sector in both developed and less developed countries. The direct approach is considered to be best, because contrary to the indirect approach, it gives specific and inside information about the participants and location of the informal sector.

In sum, a considerable amount of work has been done to analyze the informal sector phenomenon. Numerous significant findings have contributed to lighten the darkness of this new field of study. Several methods have been used to deal with it. In our view, more efforts to study it thoroughly and to find new insights should be strongly encouraged in the future. We are still a long way from really understanding this phenomenon that is of such major economic, political and social importance in all countries, developed as well as undeveloped.