

The Transition from the Informal To the Formal Sector

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Abstract— Knowing the extent of the causes and effects of the informal sector on the labour market has become an acute necessity for decision making and the efficiency of economic and social policy in general, as well as for a better identification of the tools and mechanisms of formalizing the informal sector, to protect the employees in this field. Informal employment and its derivative, the informal economy, are analyzed in terms of cause and effect regarding the theoretical and methodological elements of various trends in thinking; the analysis is based on models of informal work regarding the most significant factors that influence the avoidance of taxes and registration, the flexibility and convenience of informal work, the impact of traditions or needs determined by the high degree of poverty, the bureaucratic and extra-bureaucratic obstacles of formal labor market. This study aims at defining and describing the profile of the informally employed person, based on the main demographical, social and economic characteristics (gender, area of residence, age, ethnicity, occupation, education, economic activity, employment status, etc.). Knowing the weight of the informal economy in the national economy is an important step in the fight to diminish informal economy, known as black economy, informal economy.

Index Terms— underground economy, informal sector, labor market, tax evasion.

I. INTRODUCTION

Increasing the fight against this serious phenomenon which is the informal economy, which contains among its components the informal employment sector, has a greater purpose for any economy, which is regaining the confidence that the individual who is correct can enjoy the results of personal effort; in reality this sends an encouraging message that these results are not diverted towards those who do not make any effort to achieve them. In fact part of the contributions to the consolidated general budget is diminished by the existence of the informal sector, which affects the entire population. Moreover, by tolerating informal work as part of the informal economy creates differential treatment between individuals; then the disadvantaged will also have a tendency to migrate to the informal area, which causes problems more complicated and more difficult to manage. As the contemporary reality shows, growth and modernization do not cause the decrease and disappearance of informal sector labor market. On the contrary, the informal sector proves to be further resistant and economic growth will not lead to a decrease in the informal employment as long as:

- There are activities that fall outside national registration systems, such as farming;
- There is a strong proof showing the natural tendency of many supporters of skipping accounting activities in order to avoid taxation;
- The costs to employers in the informal sector are more important than their benefits, which turns evasion into a characteristic of employers rather than employees.

II. FEATURES OF THE INFORMAL SECTOR

The following analysis on the relationship between formal and informal labor market tries to answer the question whether in fact the informal sector in modern society has an exclusively harmful role or, on the contrary, it represents a factor propelling progress. In this context, there is a controversial issue concerning the options regarding the political options related to the informal sector or its accurate and relevant characterization; this situation requires efforts focussed on the specific intervention measures to better protect the workers within the informal labor market.

The informal sector is ubiquitous, it can be found in market economies, in developing countries and developed countries. The results in this sector influence the economy results, as the workers work, earn an income and consume.

Informal employment affects revenues, which makes governments unable to provide social services and thus distortions appear in the tax system; it also weakens the ability of the government to comply with the laws in force. Nevertheless informal employment represents the source economic growth and social security in the absence of formal social protection; it is also a source of economic growth when bureaucracy, difficult regulations and corruption may prevent private entrepreneurial activity in the formal sector of economy.

Knowing and measuring this segment has a particular importance from the point of view of economics. The production in the informal sector of the economy is not registered and usually it is not included in the indicators that measure the level of development and welfare of the population. There are estimates according to which this segment of the economy is, in some countries, about half or more of the equivalent gross domestic product (GDP). Therefore it is vital that governments and policy makers, as well as economists and scientist know whether and how large are the economic resources that a country actually has, compared to the data known and registered with statistics and official documents.

In the literature there are many terms that relate to an important segment of the labor force and economic activities, known today under the generic name of "informal". Among the most commonly used terms for this market segment are the following: unreported, undeclared, unregistered, underground, hidden, illegal, gray, shadow, parallel, black,

illegal, informal, unmeasured, untaxed, unorganized, unnoticed. The existence of all these terms proves the diversity of attempts made by economists and researchers worldwide to explore this relatively little known area of employment and economic activity.

There has been great concern in the last twenty years, marked by debates on the origin, composition and role of the informal and its contribution to national economic development. The English economist Keit Hart (1973) is the "father" of the term *informal sector*; he is the one who first used it in article entitled *Informal Income Opportunities u and Urban Employment in Ghana*. Hart described the informal sector as consisting of economic activities carried out by the segments of low-income workforce in Accra, which formed the urban under-proletariat, made of illiterate and unskilled migrants. According to Centeno and Portes (2003), *informal sector* was a concept institutionalized by the International Labour Office, which considered informality to bring along low levels of productivity and storage capacity, as well as poverty. Other specialists who studied the informal sector in developing countries, particularly in Latin America, saw things in a different light. The Peruvian economist Hernando De Soto reformulated Hart's original theme regarding the idea that informal activities are seen as a sign of popular entrepreneurial dynamism and gave a new impetus to the study of this topic. Feige (1990) identified four specific types of "underground" economic activities: illegal, unreported, unrecorded and informal; they have different relevance to various economic problems. The term *Undeclared work* was introduced in the late 90s by the European Commission. Thus, according to the European Commission Communication [1] on undeclared work it refers to "paid activities that are lawful as regards their nature but not declared to public authorities, given that differences in the regulatory systems of the Member States are to be taken into account". OECD proposed a similar definition using the term *hidden employment* to refer to the activity "which, although not illegal in itself, was not to be declared to the administrative authorities" [2]. The International Labour Office adopted two concepts that complement each other, during the International Conferences of Labour Statisticians - the 15th in 1993 and the 17th in 2003: *employment in the informal sector and informal employment*. the first concept was made in terms regarding the characterization of the production units where economic activity takes place (production or company approach); the definition of the second concept was made in terms regarding the characterization of the employed and their places of work (employment approach). A new interest in the problem of informal employment was reflected and promoted by the resolution and conclusions of the International Labour Conference in 2002 [3] on decent work and informal economy. The resolution includes conclusions on the definition and diagnosis of informal economy and deficits of decent work places, on a range of actions addressed to these deficits of decent work and to facilitate their integration into the formal economy.

The informal employment growth in developing countries in the recent decades is a major issue of debate in the economic writings. The factors that stimulate informality have a particular importance in finding possible answers to the development of appropriate policies. A set of alternative explanations is drawn from the literature [4]:

Informality can be seen largely as a result of a development model that does not produce enough good/decent jobs. The phenomenon was exacerbated by poor capacity of the private and public sectors to accommodate rapid growth of population and labor; it was aggravated by discrimination on the labor market and the segregation between men and women, between different social groups and occupations; Increasing number of subcontracting, stimulated by globalization and economic liberalization; it has led to greater diversification of informal employment forms. Consequently, there was a greater heterogeneity among informal workers and an increased number of skilled / qualified people and with a high production capacity;

Normative acts regulating the formal sector have been developed especially for large enterprises, but they are often inadequate for the needs of the growing sector of microenterprise.

Changes in labor regulations and / or implementation of labor regulations might have had an additional impact on changing the percentage of informality in economy;

Employers turned the former formal jobs into informal ones as a strategy to reduce labor costs and to withstand competition.

III. INFORMAL EMPLOYMENT AND INFORMAL EMPLOYMENT IN ROMANIA

According to some studies and research [5] conducted in households in March 2011, informal employment in Romania comprised 2.9 million people, representing 31.4% of total employment (Table No. 1).

Table No. 1 Population employed, by type of work place

	Total employed population	Formal employment (FE)	Informal employment (IE)	Employment in the informal economy (EIE)
- thousands people -				
Total	9239	6335	2904	3417
- formal (SF)	5840	5819	21	21
- informal (SI)	1209	514	696	
-households (SG)	2190	2	2188	2188
MALE	5136	3510	1626	1903
- formal (SF)	3246	3233	13	13
- informal (SI)	749	277	472	749
-households (SG)	1141	0	1141	1141
FEMALE	4103	2825	1278	1514
- formal (SF)	2954	2586	8	8
- informal (SI)	460	236	224	460
-households (SG)	1049	2	1046	1046
URBAN	5122	4786	336	740
- formal (SF)	4398	4381	18	18
- informal (SI)	644	404	239	644
-households (SG)	80	1	79	79
RURAL	4117	1549	2568	2677
- formal (SF)	1441	1438	3	3
- informal (SI)	565	109	456	565
-households (SG)	2110	2	2109	2109

Source: Voinea L.; Albu L. (coord.); Voineagu, V.; Pietreanu M.; Pisičă, S., and others., *Informal Economy And Its Effect*

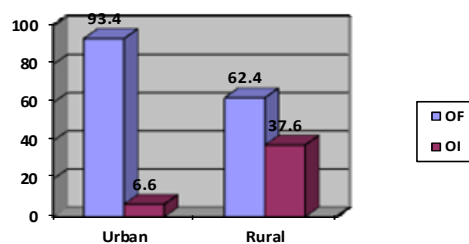
On The Labour Market, co-funded project by European Social Fund Sectoral Operational Program Human Resources Development 2007-2013 Invest In People, Bucharest 2011, http://www.bns.ro/fisiere.portal/economia_informala.pdf

Most of the informal employment is **individual household employment**, almost 2.2 million (75.2% of total informal employment). The number of people employed in the informal sector was of 1.2 million (13.1% of total employment), of which slightly more than half a million (42.5% of total employment in the informal sector) worked as employees with employment contract, but the employers are unregistered (are part of the employment in the uninformal sector, but are excluded from informal employment).

The total number of persons who are part of the employment in the informal economy is 3.4 million (i.e. informal employment plus last category listed - employees with an employment contract, but working with unregistered employers); this represents 37.0% of the total number of employed persons estimated by the statistical research made in March 2011.

Only 6.6% belong to informal employment out of the total urban population employed; this figure is higher overwhelming for rural employees 62.4% (Fig. No. 1).

Figure No. 1 The structure of urban and rural population by type of work place



Source: Voinea L.; Albu L. (coord.); Voineagu, V.; Pietreanu M.; Pisciă, S., and others., *Informal Economy And Its Effect On The Labour Market*, co-funded project by European Social Fund Sectoral Operational Program Human Resources Development 2007-2013 Invest In People, Bucharest 2011, http://www.bns.ro/fisiere.portal/economia_informala.pdf

As it can be seen, the level of informal employment in Romania can be characterized as high, characteristic of a country whose economy has undergone a process of transition to a market economy. There are multiple causes for such an extensive phenomenon: the decentralization process, when the state withdraws from the economy, privatization reforms implemented, which had as effect directly led to huge increases in unemployment, inflation and its disastrous effects and others.

Measuring the informal sector is difficult due to several reasons. The first one is its hidden character itself, in most of the cases, making it difficult to identify them. This inevitably leads to the second reason, which is the lack of data allowing a complete and accurate observation of the phenomenon. The third reason is the proposed target to be measured and monitored - informal employment or employment in the

informal sector; a particular method can be chosen depending on this.

In general, the *indirect methods* allow estimating employment in the informal sector and the *direct* ones allow estimating informal employment.

Indirect methods – which have a considerable advantage - are less expensive in terms of financial and human elements (regarding resources). It is also an advantage that they offer the opportunity to monitor the phenomenon for a long-term, as they make it possible to build longer series of time with high level of comparability. Another advantage is given by the relatively short period between the time estimates and the period (year) of reference. The main disadvantage is the questionable degree of completeness, as some segments are not covered due to the lack of data sources.

Direct methods - enable examining in detail the informal activities and persons involved in their development, which gives more detailed estimates, separated into a variety of socio-economic variables. The main disadvantage derives from the significant costs - financial and human - which are necessary to implement in practice.

IV. TRANSITION COORDINATES AND POLICIES FROM THE INFORMAL TO THE FORMAL SECTOR

To reduce, and ultimately effectively fight against informal work, comprehensive coordination of informal work is needed, to address both the macroeconomic and microeconomic level, and which:

- establish fundamental work principles and rights;
- create more and better employment and earning opportunities which increase the standard of living;
- expand the scope of social protection and a greater concern for the individual, leading to improved quality of life;
- Promote social dialogue.

The main reason which determines employers, employees and freelancers to work in the informal sector is an economic one. The activities in the informal sector provide the opportunity of gaining, completely or partly avoiding taxes and social contributions. For *employers*, the aim is to obtain tax-free or partially taxable profits with low production costs. For *employees*, the motivation is to obtain income enabling them to survive or, in some cases, higher income from tax evasion or violation of labor laws. In all countries where this phenomenon is installed and is perpetuated at high levels, public finances have suffered from unregistered work, as the sources of income are directly affected. This has immediate and lasting effects on public services tax as reduced collection involves reducing public services that the state can provide. So basically, it creates a vicious circle, as the measures to increase the taxes and other tax items to support social services in fact stimulate the phenomenon of undeclared work. The informal economy is the result of misguided, ineffective macroeconomic and social policies, as well as the result of the lack of adequate legal and institutional framework. Macroeconomic, privatization and restructuring policies lead to drastic cuts in employment in the formal economy unless they are sufficiently oriented employment issues. In the absence of sustainable economic growth, the governments' ability to facilitate the transition from informal to formal economy - by creating suitable jobs – practically lacks; there is a large group in the informal economy earning

way better than the workers in the formal economy. Most of the workers in the informal sector, however, have low and very low income, standing at subsistence level, at or below the poverty line; they form the so-called vulnerable groups, the disadvantaged parts of society. They do not enjoy security and protection of property rights, they lack access to capital and credit. They experience hardships and difficulties in terms of access to the legal system and the legal recognition of contracts (employment or business), to the infrastructure and benefits from the public system. They are also vulnerable to harassment - of any kind, including sexual - and other forms of abuse, including corruption and bribery. The young, the old, the women and the migrants are the most vulnerable to deficiencies in working conditions in the informal economy. The coordination of policies to reduce the informal sector and the transition to the formal sector should be designed so as to provide a basis for gradual transition and sure access to formal economy. The factors with the greatest potential to fight against undeclared work are those that determine economic development and, political stability, full integration into the market economy, liberalization of foreign trade.

A first step in shaping and implementing strategies and policies aimed at reducing undeclared work and transferring it to the formal sphere would be to identify the **main causes of the emergence of undeclared work** at both regional and national levels.

As a first approach we intend to point out the main causes in the European Union and then to highlight those in Romania, without knowing for sure that they are the only ones.

- in the European Union

The existence and expansion of informal work is largely linked to the institutional aspects of the economy, which differ in each of the member countries, such as:

- Tax burden - taxes and social contributions: the influence of taxes and contributions certainly influence undeclared work. The higher the tax level, the more stimulated the emergence and development of the underground economy;
- bureaucracy and administrative tasks: excessive bureaucracy, many formalities, complicated administrative procedures also contribute to discourage labor declaration;
- faulty legislation: insufficient coverage and knowledge of the regulations on working hours often lead to the use of atypical forms of employment in official documents (such as Part-time) and in reality carrying out a full program.

- in Romania

As proved by the experiences of other European Union countries, the emergence and development of the informal sector is an inevitable consequence of transition processes such as those undergone by Romania from planned to market economy. Among the causes the following can be identified:

- Areas of innovation - especially in IT - have led to informal work; such activities are easy to perform and very difficult to detect;
- Excessive bureaucracy - it refers both to the conditions in which a person can establish a business on his/her own and in terms of concluding and registering the contracts of employment;

- Faulty legislation that also had deficiencies in terms of empowering labor inspection authorities to properly detect and punish violations of labor laws.

With regard to **policies and measures to combat undeclared work**, there is a *policy* approach that brings together two perspectives, one facing penalties and another focused on prevention.

With regard to *measures to combat undeclared work* we can identify the following as most important, considering the experiences of European countries:

- Legislative and executive measures - some states have changed the specific work regulations and encouraged the access to the labor market; Spain is a good example;
- Information and awareness - actions and campaigns were initiated in order to prevent informal work and the risks involved in the performance of informal work;
- Measures regarding taxes - many countries have made changes in legislation on taxation system, especially at the individual and tax deduction possibilities;
- Measures concerning the immigration system - as regards the issue of immigrants involved in undeclared work, France introduced special measures of control.

CONCLUSIONS AND SUGGESTIONS

The reasons to hire or work outside the law vary from case to case and there is no unique and universal formula to reduce this practice.

Our opinion is that a set of policies should be correlated so that the overlapping effects have a strong positive impact towards reducing the informal market.

These policies should act as an incentive to move from the informal to the formal system. Motivating individuals to legally work should be of utmost importance; the reasoning that can be individualized according to each region, the ratio of supply and demand on the local labor market and the features of some disadvantaged groups. An important package of laws to ensure a gradual formalization of informal activities should include policies for at least four major areas with specific measures for different categories of informal workers:

- Improving the legal provisions regarding the conditions and needs of informal entrepreneurs and workers with incentives to facilitate the registration and legal recognition;
- hiring informal workers in decision-making and their participation in policy development;
- growth of earnings and the development of informal workers' potential through training.

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