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Some recent ECLAC publications.
Some thoughts on the definition of the informal sector

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Although much has been written about the informal sector in Latin America during the past 15 years, the economic concept of informality continues to be more a matter of intuition than an idea having a clearly-defined analytical content. The pioneering ILO study on the subject established the fact that the informal sector was eminently residual in nature, but it did not set up a consistent analytical framework or an appropriate statistical indicator. In the course of subsequent efforts to devise a more operational definition of the concept of informality, two approaches have gained the widest acceptance: one, which was formulated by ILO, focuses on the production rationale of the enterprises in question; the other is based on the criterion of illegality and has only recently come into use in the region, although it has been widely employed in the industrial countries. These two concurrent concepts thus have overlapping yet different coverages and aims. Each is linked to a distinct ideological orientation and therefore calls for a different terminology. Nonetheless, neither of these two definitions satisfactorily fulfills their original purpose, which is to measure the residual segments of the economy. The success they have enjoyed in the economic literature is thus due more to their potential as a means of bridging the gap between the empirical and normative aspects of economics than to their operational usefulness, which continues to be quite limited.

The informal sector has aroused an exceptional amount of interest in Latin America in recent years. So many studies have been published on this subject in such a wide range of countries within the region that this sector (which until a short time ago received very little attention in governmental and financial circles) has been explicitly incorporated into the economic policies of a number of countries and into the lending programmes of various multilateral agencies. Despite its sudden popularity, however, the economic concept of informality continues to be largely a matter of intuition rather than a clearly delineated idea. One factor which has contributed to this lack of clarity is the use of such a varied assortment of designations for this sector ("informal", "underground", "unrecorded", "non-protected", "grey", etc.). Moreover, despite the large number of empirical studies done on this sector, the available estimates as to its size in the region cover a very wide range. Yet another factor is that, although all the recent studies indicate that this sector is expanding in most of the Latin American economies, some regard this phenomenon as an unfavourable effect of the external crisis, some praise it as a reflection of the spirit of entrepreneurship, and still others have adopted countless different positions between these two extremes. It therefore comes as no surprise that the policy recommendations made in these studies are equally varied.

This great diversity of approaches to the same concept is nothing more than a reflection of the different ways in which it is defined. Indeed, the research projects carried out in this field usually start out by formulating their own

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The point is that the basic methodological element in economics, and all social science, is not the study but the story.

Benjamin Ward*

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In the case of Peru (the Latin American country whose informal sector has been studied the most) the estimates range from 20% of the labour force and 7% of the product (PREALC, 1986) to 48% of the labour force and 39% of the product (De Soto, 1986).
definition of the subject of the study, as if they were dealing with a concept that had only recently been introduced. This is hardly the case, however, inasmuch as more than 15 years have passed since the publication of the well-known ILO report on the employment situation in Kenya which is generally considered to be the pioneering study for research on the informal sector. Furthermore, almost nobody questions the existence of this sector any longer, and both the term and the concept are widely recognized in economic literature. Nonetheless, this consensus goes no further than a few empirically-observed characteristics.

When it comes to attempting to define the analytical content of the concept of informality, their own which was at odds with the prevailing belief that such activities would gradually disappear as the benefits of growth "trickled down" to the poorer strata. This group of activities was baptized the "informal sector", and emphasis was placed on the need to proceed with its active integration into development policies.

The concept of the informal sector was first used by the International Labour Office (ILO) in 1972 in a report on the employment situation in Kenya (ILO, 1972). ILO experts had noted the existence of a growing group of "employed poor" which did not fit into either category in the classic modern sector/traditional sector dichotomy since, in terms of their type of employment and location, these people belonged to the modern sector, but their income was only slightly higher than that associated with the traditional sector. A more detailed study of this group revealed that it represented a large number of people whose contribution to the national product was far from insignificant. Moreover, their activities exhibited a dynamic of

2 Actually, the anthropologist K. Hart was the first to use the term "informal income opportunities" (Hart, 1973, in a study presented in September 1971 at a conference held by the Development Studies Institute of the University of Sussex). However, the ILO report (ILO, 1972) contained a more rigorous economic analysis of the concept and was more widely disseminated in academic circles.

3 Marxist economists do not recognize the informal sector as being a valid analytical concept, although they do study the individual activities usually classified as being part of this sector. In Marxist analyses, these activities are likened to pre-capitalist forms of production. They are therefore regarded as forming part of a single economic continuum which is dominated by capitalism and thus entirely dependent upon it. For a more detailed discussion of the Marxist position, see De La Piedra (1986) and Guerry (1987).
still very imprecise in analytical terms, the expression "informal sector" rapidly gained acceptance and began to appear in numerous economic, sociological, anthropological and other studies. All of them, however, started out by presenting their own definition of the concept. This was because each of the criteria used in the ILO report may be employed, either alone or in combination with others, to define a specific segment of the informal sector, and this was what was in fact being done. As was to be expected, the findings and policy implications of these studies were equally diverse.

This situation notwithstanding, some criteria have been generally accepted as bases for an economic definition of the informal sector. The starting point for this definition is the residual character of the sector, in that it deals with economically productive activities which, for one reason or another, are not usually registered by traditional measurement techniques. Another point on which there is general agreement is that criminal activities and domestic activities are not included for reasons having to do with ethical and economic accounting conventions. Even though this point has sparked a great deal of controversy both in economics and in the other social sciences (Tanzi, 1983; Miller, 1987), there is a tacit agreement that economic policy studies will not consider these activities as being part of the informal sector.

The above-mentioned criteria are "restrictive" in the sense that they define the boundaries of the informal sector in contradistinction to other activities. They therefore implicitly delimit the total economy more than they do the informal sector as such (see figure 1). The category thus created provides a valid basis for the formulation of differing and even contradictory definitions of the concept of informality. Even so, the residual character of the sector is one of the essential criteria for its definition, as well as accounting for much of this concept's popularity in the economic literature. Indeed, the residual nature of the informal sector provides a bridge between the empirical, accounting-oriented tradition and the normative tradition in economics. In combining that which is "not measured" and that which is "not regulated" within a single concept, the notion of the informal sector has the potential to resolve both of the two main difficulties it poses in relation to traditional economics: an incomplete picture of the situation and the consequent inability to conceptualize the phenomenon properly.

Thus defined, however, informality is a comprehensive concept which, while lending itself to various definitions, is still too broad to be useful at either the empirical or the analytical level.

In order to arrive at an operational concept of the informal sector, a positive criterion needs to be incorporated which will both give the phenomenon an analytically coherent dimension and link it to indicators based on empirical measurements. The various empirical studies carried out during the past decade have suggested a number of provisional definitions. Two of the many approaches used deserve special attention by virtue of the fact that they have served as implicit or explicit points of reference for the vast majority of the studies that have been done: one of these approaches focuses on the production rationale that is involved, while the other focuses on the criterion of illegality.

4In addition to the theoretical controversy, practical problems of measurement are also involved. These problems are especially acute in relation to developing countries, particularly when it comes to trying to draw a precise distinction between criminal and non-criminal activities in cases where the former are extraordinarily widespread and influential (e.g., the drug traffic in some countries of the region) and between strictly private domestic activities (such as cooking and childrearing) and productive but unpaid domestic activities (assistance by family members).
The ILO and, at the regional level, the Regional Employment Programme for Latin America and the Caribbean (PREALC) laid the groundwork for a definition of the informal sector by describing it as the sum of those activities characterized by a discrete logic of production differing from that prevailing in the visible portion of the economy (PREALC, 1981; Sethuraman (ed.), 1981; and Tokman, 1987). The informal sector is therefore defined as the sum of those activities carried out by enterprises organized in accordance with a particular economic rationale, whose object is to guarantee the subsistence of the family group. This rationale thus differs from that of the formal (capitalist) sector, whose prime motivation is accumulation.

The particular rationale of the informal sector is, then, regarded as the logical source of its other characteristics. The objective of its activity determines, to a large extent, the way in which it organizes production (choice of open or relatively unrestricted market segments, labour-intensiveness) and its main features (low productivity and income level).

Furthermore, the production rationale approach stresses the employment aspect of the question, as is natural in view of the fact that it was initially developed by ILO with a view to its world employment programme. According to this approach, the factors responsible for the emergence of the informal sector are closely related to the labour market and the distribution of income. The informal sector is seen as being the result of a manpower surplus in respect of employment in the formal sector, most of which is made up of rural migrants who cannot find work in the modern urban sector and who must devise some way of obtaining an income. In keeping with this initial approach, solutions for the problems of the informal sector are usually sought in the sphere of employment and income policies.

While an explicit agreement in this respect has not been reached and analytical controversies continue to produce a good deal of literature, the production rationale approach has come to be quite widely accepted by those doing research into the informal sector in the developing countries. Nevertheless, in a number of recent studies on this sector in the Latin American countries, a new definition has been used: the informal sector as that group of activities which are illegal in the sense that they do not comply with economic regulations pertaining to fiscal, employment, health or other matters (CEESP, 1987; De Soto, 1986; ILD, 1987; ILDV, 1987 and IDEC, 1987). According to this approach, then, illegality is the main characteristic of informality, with all its other aspects being defined on this basis. According to the former approach, on the other hand, illegality is a related characteristic of informality and possibly even a frequent one, but by no means is it regarded as a basic trait thereof. In addition, unlike the productive rationale approach, the illegality-based approach assumes that the economic rationales of formal and informal enterprises are identical and that the only distinction between the two is their legal status, which, in its turn, gives rise to differences as regards their access to resources and markets.

According to this second approach, the appearance of "illegal" production activities is due to the existence of flaws in the tax system and in prevailing laws and regulations. In contrast to the interpretation associated with the production rationale approach, the emergence of the informal sector is not regarded as being caused by certain factors inherent in the existing economic and social structure, but rather by the policies that are applied. Consequently, these two approaches arrive at diametrically opposed conclusions. As mentioned earlier, the initial research projects done on the informal sector

Some authors, although they agree that the production rationale is a basic characteristic, place great importance upon the analysis of the corresponding labour market (Tokman, 1987), while others regard the informal sector as a sector having its own dynamics (De La Piedra, 1986). There is also some disagreement as to which unit of analysis is the most appropriate (firms, individuals or households), what degree of autonomy or dependence is exhibited by the informal sector with respect to fluctuations in formal activities, the nature of the informal sector's means of adjustment and how it behaves within the context of the short-term economic cycle, etc. For a more extensive discussion in this connection, see Raczynski (1977), De La Piedra (1986), Miller (1987) and Tokman (1987).
were a direct result of the disenchantedment of some experts with the theory that the benefits of development would eventually trickle down to the poorer sectors; accordingly, they strove to guide— and, ultimately, to justify— the State’s intervention in certain areas (ILO, 1972, pp. 305-503; Sethuraman, 1976, p. 69). In contrast, in recent studies on the illegal economy in the developing world, experts have urged that the laws should “reflect actual circumstances [in the informal sector] and allow the economy which is spontaneously generated by the people to function” (De Soto, 1986, p. 299) and, in consequence, they have advocated the deregulation of markets and the almost complete withdrawal of the State.

The illegality-based approach, although it has come into use only recently in studies on Latin America, has figured prominently in analyses of the informal sector in both free-market and centrally-planned industrial economies. (Tanzi, 1982; Alessandrini and Dallago, 1986.) The application of this same theoretical framework to different regions has, however, given rise to some divergencies. One relates to terminology: in the industrial countries, illegal activities as a group have frequently been referred to as the “underground economy”, although there is no consensus in this regard either. Another is that the experts doing research on illegality in these countries often recommend that the pertinent regulations be improved upon so as to increase their effectiveness, rather than advocating their dismantlement. These studies have often been headed by the economic authorities themselves, and the idea of economic illegality has therefore come to be an important frame of reference, especially in the design of fiscal policy.

The two main approaches to the analysis of the informal sector which have been summarized above are more notable for their differences than for their similarities. Since, they overlap only partially, the two definitions do not have the same coverage (see figure 2). On the one hand, there is a high probability that activities performed in order to generate a basic family income will be illegal, but some, such as paid domestic service, may be entirely legal. On the other hand, various activities are carried out that are not in compliance with prevailing tax laws for the purpose of increasing the earnings of either enterprises or individuals in line with the classic logic of capitalism.

The differences are equally striking when it comes to the formulation of policy recommendations. Indeed, the definition used varies according to the practical objective of the research project. Naturally, when the aim is to improve the tax structure, the study focuses on those activities conducted outside that structure; similarly, an attempt to raise the productivity of labour calls for a better understanding of low-productivity activities. The definition of these objectives is not, however, free of all ideological influence. As Fishlow has said, “prior beliefs” serve to identify both the problems and the solutions in the realm of the political economy (Fishlow, 1985). In other words, the ideological leanings of economists implicitly influence their choice of criteria for defining a concept and the related problems, as well as for determining what tools they will recommend for solving the latter.

*Tanzi (1983) discusses potential forms of illegality in the developing countries, but few empirical studies have been carried out to date.*
The ideological tendencies underlying each definition of the informal sector are relatively easy to identify. The production rationale approach corresponds to the Keynesianism which gained sway in the West after the war. This approach is founded upon a belief in the role of the State in countering phases in the economic cycle and reallocating resources, which is why it tends towards policy recommendations based on the management of aggregate demand. The illegality-based approach, on the other hand, is more closely associated with the classic position in traditional economies and, more recently, with the postulates of supply-side economics. Its basic tenet is the belief that resources are allocated most efficiently when markets are allowed to operate freely, without State regulation or intervention. The difference between these two positions can be seen even more clearly when their respective policy proposals are compared. One focuses on State action as a means of changing the distribution of income and, consequently, the pattern of demand for goods and services. The other tends to stress the reduction of the tax burden (direct and indirect) and, hence, the influence of the State as means of altering the supply of the factors of production and investment levels.

The dissimilarities displayed by these two approaches clearly justify the use of different terminologies, i.e., the use of terms relating to the concept as such rather than to the geographical universe of the study. It would appear more logical to use the expression "informal sector" in connection with what has been described here as the production rationale approach, while the term "underground economy" would seem to correspond more closely to the category of activities that are carried out illegally, even if they do not constitute criminal offenses. This does not mean that one approach is more useful, effective or realistic than the other, but the experts on this subject, as well as their readers, would obviously benefit from a greater degree of conceptual and terminological precision.

Despite the differences between these two approaches, their original purpose is the same: to measure and conceptualize the "residual" segments of the economy. Unfortunately, neither of the two definitions examined above fulfills this purpose entirely satisfactorily. As already noted, in order to make the initial concept truly operational, a positive criterion is needed that will make it possible to establish an analytical framework and a measurable indicator. Neither of the two criteria discussed above performs this dual function fully. The production rationale criterion, although analytically consistent, does not provide a sufficient basis for a satisfactory empirical study. In fact, it has proved impossible to associate this concept with a statistical indicator that can be used for macroeconomic accounting purposes. For this reason, empirical studies of the informal sector based on this approach have had to rely on specific qualitative surveys and, in most cases, have even adopted other indicators, such as firm size, income level or the number of hours worked. The analytical conclusions reached in these studies have therefore been based on ancillary classifications (small firms as a group, poverty or underemployment) and the studies have thus not succeeded in identifying the informal sector in terms of any real economic category.

Conversely, the illegality-based approach as applied in the Latin American countries has suffered from severe analytical shortcomings. Although various techniques that were initially developed in the industrial countries have been used to measure illegality, their application has not always been coupled with original conceptual interpretations which would have permitted the adaptation of these techniques to the specific circumstances of the region. The use of concepts and methodologies developed on the basis of empirical studies of the industrial countries and their extrapolation, without any major modifications, to the developing economies is a questionable practice. Although, in theory, there are "universal" economic principles and problems, in practice they are not as uniform as might be thought (Wilber and Harrison, 1978). In point of fact, many economic "problems" do not take the same form in all countries or in all regions, to say nothing of all economic systems. Moreover, in the majority of the studies conducted on illegality in industrial economies, an effort has had to be made to conceptualize the specific role of the State and, in parallel with this, of the corresponding indicators and measurement techniques. While the well-known studies have concerned the centrally-planned economies,
even the analyses of the industrial economies have involved a detailed examination of the conceptual differences between economic illegality in the United States and its equivalent modality in Western Europe (Alessandrini and Dallago, 1986; Tanzi, 1982).

The absence of similar efforts in the case of the developing countries creates a number of problems. The first relates to the frame of reference used. Obviously, the role of the State is not the same in the Third World as it is in the industrial economies. Nonetheless, in most of the studies done on illegality in Latin America, this role has not been precisely defined and, as a result, these analyses are marked by an excessive bias against State intervention, to which they attribute all the distortions that are detected. These studies do not make a constructive contribution to a reappraisal of the role of an effective “developmental” State (Fishlow, 1985, p. 145), an endeavour which is an essential part of the current re-working of economic thought in the region (Fishlow, 1985).

The difficulties created by the lack of an exact definition of the problem are compounded by the failure to properly adapt the indicator that is used. The concept of open unemployment, for example, is a widely accepted indicator of occupational problems in the industrial countries. However, it does not have the same significance in the economies of the Third World. Thus, two apparently similar elements may perform different functions according to the context in which they are employed. The logical conclusion is that different indicators are needed to evaluate different situations in order to avoid lapsing into stereotypes. The indicators used in the studies on illegality conducted in the countries of the region are not entirely suited to the situations being examined. It is doubtful that an indicator developed in reference to a broad and coercive regulatory structure will have the same significance when it is applied to countries in which the tax base is very narrow and coercive measures are weak. The number of laws and of agencies responsible for applying them does not serve as an indicator of the degree to which an economy is regulated unless the extent to which these laws are actually obeyed is also considered. In other words, a distinction has to be made between regulation in theory and regulation in actual fact; the former depends upon the legal structure and the latter on law enforcement. There may, in theory, be a large number of legal provisions in a given country, but unless they are strictly applied, the actual degree of regulation will be extremely low. This is, in fact, the case in most of the countries of the region. The concept of a “rule” thus ceases to serve as an indicator, as what is theoretically illegal may well constitute an everyday practice. The category, defined thusly, is therefore too broad to fulfil its original purpose as a measurement.

These considerations notwithstanding, the illegality-based approach retains its analytical potential as regards the developing economies. There is no doubt about the fact that the considerable incidence of tax evasion, contraband and other forms of “economic illegality” are part of the Latin American scene and consequently merit attention. Therefore, any study on the subject should be preceded by an effort to define both the concepts and tools which will make it a useful means of improving the design of economic policies in the region.

IV

Some final observations

As mentioned at the beginning of this article, the concept of the informal sector has been a popular one throughout virtually the whole of the past 15 years. However, this popularity has been due more to the prospects opened up by its initial introduction than to the way in which the concept has been developed during that period. The original attempt to build a bridge between what was measured and what was regulated, between a real perspective and a moral one, between the empirical and the normative, is what has made the concept of informality attractive from the
most divergent viewpoints and for the most varied aims. Furthermore, this type of concept is an ideal tool for identifying "emerging" ideas and for bringing to the fore what were formerly latent concerns in academic and government circles. It should therefore come as no surprise that the fragmentation of economic thought in the region which has been noted in other studies should have crystallized around this concept. “No single and objective description of underlying economic relationships will be agreed upon by all” (Fishlow, 1985, p. 145). At the same time, the change of focus as regards policies on the informal sector associated with the transition from a policy of intervention to one of laissez-faire reflects the impact which the present recession in Latin America has had on economic thinking. When these economies were growing, the problem came down to being one of giving apparently lagging sectors a share in the benefits of development; during the recession, however, the apparently most dynamic areas come to be the focus of efforts to find a way out of the situation for the formal economy itself. In addition, given the current decrease in external financing — the classic "grease" for the wheels of development — a “spontaneous” form of growth that is not dependent on external assistance certainly has its attractions.

In principle, the continued elaboration of the approaches available to analysts cannot but have a positive effect on economic thinking in the region. The proliferation of approaches in respect of a single concept, however, is not conducive to efforts to arrive at a more refined definition, assuming that the ultimate purpose of the studies in question is to formulate appropriate policies. It is therefore highly unfortunate that, despite the numerous studies conducted during the past 15 years and despite the publicity given to some recent publications on the subject, a truly operational definition of the concept of the informal sector is still lacking.

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