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18 The Informal Economy

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The set of activities that comprise the informal economy is vast and offers a unique instance of how social forces affect the organization of economic transactions. We describe in the following sections the history of the concept, its changing definitions, and the attempts made to measure it empirically. However, our main aim in this chapter is to highlight the paradoxical character of informal economic activity and the way in which social structures decisively affect its onset and development.

The phenomenon of the informal economy is both deceivingly simple and extraordinarily complex, trivial in its everyday manifestations and capable of subverting the economic and political order of nations. We encounter it in our daily life in such simple activities as buying a cheap watch or a book from a street vendor, arranging for a handyman to do repair work at our home for cash, or hiring an immigrant woman to care for the children and clean the house while we are away. Such apparently trivial encounters may be dismissed as unworthy of attention until we realize that, in the aggregate, they cumulate into the billions of dollars of unreported income and that the humble vendor or cleaning woman represents the end point of complex subcontracting, labor recruitment, and labor transportation chains.

We do not commonly realize that the clothing we wear, the restaurant meals we eat, and even the laptop computer we regularly use may have something to do with the informal economy. In fact they do, and the intricate ways in which informal labor and goods enter into production and distribution chains underlie both the lower cost of the final products and their ready availability. To take the mystery away from these assertions, we will simply mention the facts underlying them: (*a*) The garment industry that produces the clothing items we buy and use is commonly anchored, at the other end of the production chain, by unregulated or poorly regulated sweatshops and home workers sewing, stitching, and packing for a piece rate and with no social benefits (Fernández-Kelly and Garcia 1989; Gereffi 1999); (*b*) the "back of the house" staff that does much of the cleaning and food preparation in many restaurants is composed of immigrants, frequently recently arrived and undocumented, who are paid in cash and are not covered by labor contracts (Chavez 1988); (*c*) the computer industry that produces our laptops is known for subcontracting assembly of circuit boards and other components to small, often unregulated shops and even home workers; these subcontractors are paid a piece rate in an updated version of the "putting out" system. Lozano, who studied these practices in Silicon Valley, concludes that

> the computer industry requires a reliable supply of basic components that can be delivered quickly. Many small and medium-sized firms compete effectively as subcontract vendors with operations overseas. One of my respondents works for such a subcontractor out of her garage, putting together the most labor intensive portion of an assembly. . . . Rush, jobs, custom work, confidential projects—managers describe them as rare events. . . . But when all these rare events are aggregated, we find that every day another "entrepreneur" . . . joins the ranks of the self-employed. (1989, 54, 59)

The examples could be multiplied. However, our purpose is not to describe the vast range of informal enterprises covered in the literature, but to explore how these activities interact with existing social structures and the policies and enforcement practices of national states. It is in these interactions that the paradoxical character of the informal economy emerges clearly and where its lessons for both economic and sociological theories of market behavior are shown most compellingly. After examining alternative definitions and measurement approaches, we focus on these dynamics centered on four paradoxes: the social underpinnings of the informal economy; its ambiguous relationships with state regulation; its elusiveness; and its functionality for the economic and political institutions that it supposedly undermines.[1]

Definitions

Origins of the Concept

The concept of informal economy was born in the Third World, out of a series of studies on urban labor markets in Africa. Keith Hart, the economic anthropologist who coined the term, saw it as a way of giving expression to "the gap between my experience there and anything my English education had taught me before" (1990, 158). In his view, the empirical observations about popular entrepreneurship in Accra and other African capitals were at odds with received wisdom from "the western discourse on economic development" (1990, 158).

In his report to the International Labour Office (ILO), Hart postulated a dualist model of income opportunities of the urban labor force, based largely on the distinction between wage employment and self-employment. The concept of informality was applied to the self-employed. Hart emphasized the notable dynamics and diversity of these activities that, in his view, went well beyond "shoeshine boys and sellers of matches" (1973, 68). This dynamic characterization of the informal sector was subsequently lost as the concept became institutionalized within the ILO bureaucracy, which essentially redefined informality as synonymous with poverty. The informal economy was taken to refer to an "urban way of doing things" characterized by (1) low entry barriers in terms of skill, capital, and organization; (2) family ownership of enterprises; (3) small scale of operation; (4) labor-intensive production with outdated technology; and (5) unregulated and competitive markets (Sethuraman 1981; Klein and Tokman 1988).

Additional characteristics derived from this definition included low levels of productivity and a low capacity for accumulation (Tokman 1982). In later publications of the ILO's Regional Employment Programme for Latin America (PREALC), employment in the informal sector was consistently termed *underemployment* and assumed to affect workers who could not gain entry into the modern economy (PREALC 1985; Garcia 1991; Klein and Tokman 1988). This characterization of informality as an excluded sector in less developed economies has been enshrined in numerous ILO, PREALC, and World Bank studies of urban poverty and labor markets (Sethuraman 1981; Gerry 1978; Perez-Sainz 1992).

This negative characterization of the informal sector has been challenged by other students of the subject who see it in the opposite light. From this alternative stance, informal activities are a sign of the popular entrepreneurial dynamism, described by Hart (1990, 158) as "people taking back in their own hands some of the economic power that centralized agents sought to deny them." The Peruvian economist Hernando de Soto reformulated Hart's original theme and gave it renewed impulse. In *The Other Path* (1989), de Soto defines informality as the popular response to the rigid "mercantilist" states dominant in Peru and other Latin American countries that survive by granting the privilege of legal participation in the economy to a small elite. Hence, unlike its portrayal by ILO and PREALC as a survival mechanism in response to insufficient modern job creation, informal enterprise represents the irruption of real market forces in an economy straitjacketed by state regulation (Portes and Schauffler 1993).

Contemporary Definitions

The strong normative component attached to these competing analyses of the informal sector in the Third World is not entirely absent in the industrialized countries, but research there has attempted to arrive at a more precise and less tendentious definition. There appears to be growing consensus among researchers in the advanced world that the proper scope of the term *informal sector* encompasses "those actions of economic agents that fail to adhere to the established institutional rules or are denied their protection" (Feige 1990, 990). Or, alternatively, it includes "all income-earning activities that are not regulated by the state in social environments where similar activities are regulated" (Castells and Portes 1989, 12). These definitions do not advance an a priori judgment of whether such activities are good or bad, leaving the matter to empirical investigation. In this sense, they seem heuristically superior to those used in the Third World, which anticipate from the start the conclusions to be reached. However, even neutral definitions are hampered by the very breadth of the subject matter they try to encompass. Writing from the perspective of the new institutional economics, Feige proposes a useful taxonomy as a way of specifying the relevant universe further. His classification is based on the institutional rules that go unobserved by a particular economic activity. Under the umbrella term *underground economy,* he distinguishes four subforms:

1. The *illegal* economy encompasses the production and distribution of legally prohibited goods and

services. This includes such activities as drug trafficking, prostitution, and illegal gambling.

2. The *unreported* economy consists of actions that "circumvent or evade established fiscal rules as codified in the tax code" (Feige 1990, 991). The amount of income that should be reported to the tax authorities but is not represents a summary measure of this form.
3. The *unrecorded* economy encompasses activities that circumvent reporting requirements of government statistical agencies. Its summary measure is the amount of income that should be recorded in national accounting systems but is not.
4. The *informal* economy comprises economic actions that bypass the costs of, and are excluded from the protection of, laws and administrative rules covering "property relationships, commercial licensing, labor contracts, torts, financial credit, and social security systems" (Feige 1990, 992).

Of course, there is much overlap between these various forms since activities termed informal are also, for the most part, unrecorded and unreported. The most important conceptual distinction is that between informal and illegal activities, since each possesses distinct characteristics that set them apart from the other. Sociologists recognize that "legal" and "criminal," like "normal" and "abnormal," are socially defined categories subject to change. However, illegal enterprise involves the production and commercialization of goods that are defined in a particular place and time as illicit, while informal enterprise deals, for the most part, with licit goods.

Castells and Portes (1989) clarified this distinction in the diagram reproduced as figure 1. The basic difference between formal and informal does not hinge on the character of the final product, but on the manner in which it is produced and exchanged. Thus, articles of clothing, restaurant food, or computer circuit boards—all perfectly licit goods—may have their origins in legally regulated production arrangements or in those that bypass official rules. By explicitly distinguishing these three categories—formal, informal, and illegal activities—we can explore their mutual relationships systematically, a task that becomes difficult when illegal and informal are confused. Blanes Jimenez (1989), for example, analyzed the pervasive effects of the Bolivian drug economy on that country's formal and informal sectors. Similar interrelationships were studied in the former Soviet Union and its Eastern European satellites by Stark (1989) and Grossman (1989).

I. Definitions:
+ = Licit
− = Illicit

Process of Production and Distribution	*Final Product*	*Economic Type*
+	+	Formal
−	+	Informal
−	−	Criminal

II. Relationships:

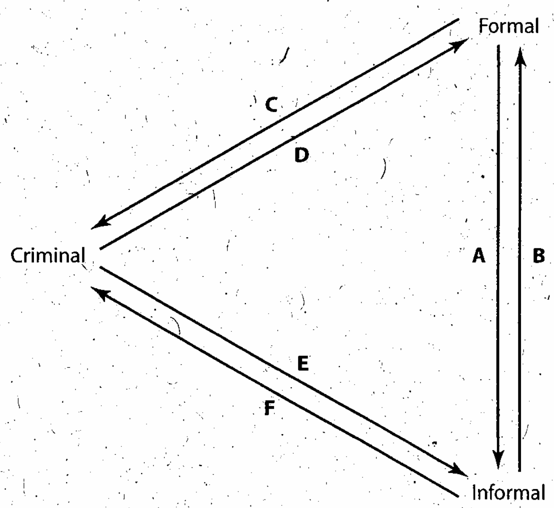

FIGURE 1. Types of economic activities and their interrelationships. A. State interference, competition from large firms, sources of capital and technology. B. Cheaper consumer goods and industrial inputs, flexible reserves of labor. C. State interference and disruption, supplies of certain controlled goods. D. Corruption, "gatekeeper's rents" for selected state officials. E. Capital, demand for goods, new income-earning opportunities. F. Cheaper goods, flexible reserves of labor.
Source: Castells and Portes 1989, 14.

A Functional Typology

These studies plus a number of others have given rise to a functional classification of informal activities according to their goals. Such activities—always defined as those taking place outside the pale of state regulation—may aim, first, at the survival of the individual or household through direct subsistence production or through simple sale of goods and services in the market. Second, they may be oriented toward increasing managerial flexibility and decreasing labor costs of formal sector firms through off-the-books hiring and subcontracting of informal entrepreneurs. Third, they may be organized for capital accumulation by small firms through mobilization of their solidary relationships, greater flexibility, and lower costs. These three types are labeled informal economies of respectively *survival*, *dependent exploitation*, and *growth* (Portes, Castells, and Benton 1989). The self-construction of shelter and the proliferation of street vending in cities of the Third World are commonly cited as examples of the first type (Roberts 1989a; Cross 1998). The relationships between underground immigrant subcontractors, jobbers, and large firms in the U.S. apparel industry provide an example of the second (Waldinger 1986; Sassen 1989; Schoepfle and Perez-Lopez 1992). The highly successful networks of artisan microproducers in central Italy represent an instance of the third (Sabel 1986, 1989; Capecchi 1989).

In practice, the three types are not mutually exclusive, either in terms of their coexistence in the same urban settings or in the intentions of participants. Thus, the same work that represents survival for an informal laborer may be appropriated as flexibility by the formal firm that hires him or her. Similarly, informal subcontractors linked in subordinate relations with larger firms may amass sufficient capital and cooperative ties to launch themselves into an autonomous path of growth. The three types are distinguished less by the motivation of actors than by the successively more complex levels of social organization that they require. Hence, while survival strategies of informal vendors in Third World cities are by no means simple, they are in a plane different altogether from the complex coordination required by an entire community of producers to achieve sustained growth (Benton 1989; Sabel 1994; Brusco 1982).

A final definition of informality, pioneered by Gershuny, Pahl, and other British sociologists, links the concept with the self-provisioning of goods and services by households in developed economies (Gershuny 1978, 1985; Pahl 1980; Pahl and Wallace 1985). Such activities as home repair or vegetable gardening represent direct subsistence production, except that they are not carried out by impoverished actors, but by middle-income households seeking to maximize the efficient allocation of time. Self-provisioning represents a kind of activity different from those labeled informal since it neither contravenes state regulation nor involves active market participation. Indeed, the principal aim of self-provisioning is to withdraw certain areas of household consumption from dependence on marketed goods and services. This set of activities studied by English researchers falls, more properly, under the category of direct subsistence production.

The Social Dynamics of Informality

The Paradox of Embeddedness

Because of the absence of state regulation, informal transactions are commonly portrayed as the play of pure market forces. Indeed, celebratory accounts of the informal economy often define it as the irruption of the "true market" in an otherwise straitjacketed economy stifled by state regulation (de Soto 1989). Based on his African experience, Hart (1990, 158) called it the "untamed market" and declared that such liberating practices are becoming global in scope. On the eve of Communism's demise in Eastern Europe, a number of analysts argued that the free market forces unleashed by the informal or "second" economy in these countries were a key solvent that undermined the political legitimacy of state socialism and would lead to its ultimate implosion (Grossman 1989; Borocz 1989; Gabor 1988; Rev 1986).

The substantive problem is, however, that the absence of state regulation in informal exchange opens the door for violations of normative expectations and widespread fraud. The question arises: In the absence of supervisory agents, who is to control unscrupulous producers, purveyors of adulterated goods, and defaulters on loans? Isolated arm's-length transactions may still occur among strangers, such as the quick sale of a contraband good, but the activities that require greater resources and a longer time perspective are subject to every kind of uncertainty and peril. The problem manifests itself even at the level of short-term face-to-face transactions. The immigrant laborers who are commonly seen standing on street corners waiting for work in New York, Miami, Los Angeles, and other cities exemplify the dilemma (Stepick 1989; Millman 1992; Cornelius 1998). They are commonly picked up by contractors who hire them for days or even weeks only to defraud them at the end by paying them lower wages than originally promised. In the absence of a contract and a secure legal status in the country, how are these immigrants to seek redress?

It is worth noticing the significant difference in this respect between practices defined as illegal or as informal. Illegal enterprise that provides illicit goods or services on a recurrent basis is always accompanied by some means of enforcing agreements, usually by force. This is the role played by the pimp in prostitution, the bouncer in underground night spots, and the professional enforcer in Sicilian crime families (Gambetta 1993). Here the illegal economy is closer to the formal in the sense that both possess established systems of redress and enforcement, be they through the police and the courts or through specialized enforcement personnel. In contrast, many of the practices defined as informal are devoid of such protection. The garment subcontractor who delivers one hundred shirts to an informal middleman on the promise of future payment is entirely at the mercy of that promise. Similarly, the immigrant worker who is hired informally by a labor contractor has no means of enforcing his claim to the stipulated wage.

The first paradox of the informal economy is that the more it approaches the model of the "true market," the more it is dependent on social ties for its effective functioning. The dynamics that Granovetter (1985, 1993) labeled "the problem of embeddedness" are nowhere clearer than in transactions where the only recourse against malfeasance is mutual trust by virtue of common membership in some overarching social structure. Trust in informal exchanges is generated both by shared identities and feelings and by the expectation that fraudulent actions will be penalized by the exclusion of the violator from key social networks and from future transactions. To the extent that economic resources flow through such transactions, the socially enforced penalty of exclusion can become more threatening, and hence effective, than other types of sanctions.

The Central Italian Informal Economy

Examples of this paradox abound in the literature. The famed Italian industrial district in the central region of Emilia-Romagna is composed of small, highly dynamic firms many of which started as informal enterprises and continue to use informally produced inputs and labor. According to Capecchi, relationships of *complicity* rather than of exploitation or pure competition characterize the daily interactions between employers and workers and among owners of firms. Small enterprises in textiles, ceramics, metallurgy, and others seek to respond quickly to market demand, specializing in particular market niches, cooperating with each other in meeting sudden surges in demand, and resisting outside manipulations to undercut prices. Workers are hired informally, but are paid reliably and are treated as apprentices who eventually may be able to set up their own firms:

> [M]any small firms concentrated on performing certain manufacturing operations or on producing certain manufacturing operations or on producing certain parts of the machine. . . . Thus a subsystem of enterprises gradually evolved in which there was no leading firm. The factory that produced the final good did not necessarily constitute the center of the system because its role was often only that of assembling various parts produced by other firms. (Capecchi 1989, 200–201)

This system of egalitarian flexible specialization, explicitly opposed to the regulatory dictates emanating from the central government in Rome, is anchored in tightly bound community networks identified by a common political culture. Emilia-Romagna is the core of the Italian "red belt" that witnessed militant organized opposition to the Fascist regime and, subsequently, to the designs of Christian Democratic governments to industrialize the nation on the basis of mass-producing companies concentrated in Turin and other northern Italian cities. Instead, the Communist regional government of Emilia-Romagna encouraged and sponsored skilled workers and artisans to develop their own firms as an alternative to deskilling and mass migration north. The successful small firms thus created were not isolated instances, but became embedded in an overarching normative framework. This framework promoted solidarity grounded on a common history and political outlook and ostracized those behaving as "true" market competitors. Such a normative structure allowed the industrial system *as a whole* to compete effectively in export markets (Brusco 1982; Sabel 1986, 1994).

Williamson (1975, 1994) has emphasized the counterpoint between hierarchies and markets as alternative forms of conducting business and maximizing efficiency. As is well known, hierarchical transactions are those conducted under the command structure of the firm; market exchange involves arm's-length contact between impersonal profit maximizers. The operation of the informal economy is characterized by the general *absence* of both of these forms of exchange and their substitution by socially monitored transactions. Lacking any hierarchical system or any legal means to sanction contractual irregularities, the success of informal enterprise is predicated entirely on this third form of regulation. Powell (1990, 317) labels it the *network form* of economic organization and describes its operation as involving "scant separation of formal business roles and personal roles. One's standing in one arena often determines one's place in the other. As a result, there is little need for hierarchical oversight, because the desire for continued participation successfully discourages opportunism."

Informality under Socialist Regimes

By definition, informal economic activities bypass existing laws and the regulatory agencies of the state. It follows that the more pervasive the enforcement of state rules and the greater the penalties for violation, the more socially embedded informal transactions must be. This is so because their success in highly repressive situations depends not only on preventing malfeasance by partners but on avoiding detection by the authorities. Secrecy in these situations demands a high level of mutual trust, and the only way trust can be created is through the existence of tight social networks.

The operation of the Jewish informal economy in the former Soviet Republic of Georgia represents a good example of this situation. The system centered on the clandestine production and distribution of consumer goods. Production took place in state-owned factories and with state-provided raw materials in direct violation of official rules. Heavy prison sentences awaited those caught. Despite this threat, the system flourished and functioned smoothly for years (Lomnitz 1988, 51). It required securing low official production targets and a high wastage allowance to accommodate clandestine production. Bookkeeping was systematically altered. Production lines, for example, were declared "in maintenance" at times of peak unofficial production. Substandard parts and inputs were used to fulfill the official quota in order to increase the supply of parts going into clandestine goods.

Georgian Jews could sustain this complex informal system only through the operation of strong networks cemented on a common culture and historical experience. Altman (1983, 4–6), who studied the system, observed, "Trust is a fundamental requirement in the operation of the second economy. . . . A man's word has to be his bond." In case of trouble with the authorities, such as police raids and infiltration by state agents, the network bailed out threatened members and obliterated incriminating evidence (Lomnitz 1988, 52). The high level of mutual trust required to overcome totalitarian repression was reinforced by periodic rites of solidarity that included lavish feasts in which other network members were entertained, often at great expense (Altman 1983).

High levels of state repression and external threat clearly strengthen solidarity bonds among those involved in informal activities. Bounded solidarity among network members—symbolized and strengthened by the rites just described—represents an added element supporting clandestine transactions and preventing breaches of secrecy (Lomnitz 1988). Nevertheless, it is not a spontaneous feeling of solidarity, but the enforcement capacity of the community that constitutes the ultimate guarantee against violations.

Recent reports from Cuba—the last formally socialist regime in the west—confirm these observations. Despite the threat of heavy fines and prison terms and the omnipresence of the state, the Cuban informal economy has flourished, comprising, according to a recent estimate, up to 40 percent of the national domestic product in 2000 (Roque 2002; Henken 2002). There are clandestine factories making and repairing motors for water pumps and refrigerators, manufacturing soft drinks and beer, and producing cigars for export. Home construction and, especially, home repairs are increasingly informalized. In all instances, inputs for production, construction, and repairs come from thefts of state property.

While short-term transactions involving black market goods do not require any particular social bond, entire clandestine factories and marketing enterprises are invariably undergirded by family and other ties between implicated state personnel, middlemen or *bisneros* (from "businessman"), and final consumers. As in Soviet Georgia, those bonds are indispensable for generating enforceable trust, which, in turn, makes possible extensive and sustained informal enterprise:

> Legally, it is impossible to own a small enterprise in Cuba. Yet there is a great variety of clandestine enterprises with a notable capacity of innovation and accumulation. . . . When one enters the exclusive zone of Maramar in Havana, vendors call in a low voice "microwave," "air conditioner," "bedroom set," "parabolic antenna" . . . a great variety of products forbidden to Cubans. Where do they get them? Without doubt from state supplies, but there are also clandestine networks departing from the special export processing zones. Here we find everything: theft, corruption, speculation, delivery of products by foreign firms to their Cuban workers for sale in the black markets. (Roque 2002, 10–11)

The Role of the State

The Paradox of State Control

As an example of what he calls the "predatory state" in the Third World, Evans (1989) describes the case of Zaire. Under the long regime of Mobutu Sese Seko, the Zairian state degenerated into a collection of fiefdoms—offices freely bought and sold—that thrived on the collection of "gatekeepers' rents" from firms and from the population at large. The situation is one in which state officials squeeze resources from civil society "without any more regard for the welfare of the citizenry than a predator has for the welfare of its prey" (Evans 1989, 582). Evans notes that this is an extreme example, buttressing the critique by public choice theorists about the nefarious consequence of state interference in the economy. For public choice advocates, all states sooner or later become predatory (Buchanan, Tollison, and Tullock 1980).

The logical corollary of this position, and more broadly that advanced by neoutilitarian theorists, is the complete removal of state interference from the market as inimical to its development. This position finds an enthusiastic Third World echo in the critique of the mercantilist state advanced by de Soto and his followers. There is, however, another perspective from which the behavior of rapacious state officials may be described. More than predators, these officials can be defined as de facto employees of outside entrepreneurs who hire their services in order to obtain privileged access to scarce government resources—be they contracts or the nonobservance of regulations. The more state officials are willing to bend the rules for a price, the more the situation approaches that of a free market in which goods and services—in this case those purveyed by the state—are sold to the highest bidder (Moya-Pons 1992).

This marketization of the state does not represent the triumph of the informal economy so much as the elimination of the distinction between the two sectors. Where the state does not regulate anything because it is at the mercy of market forces, there is no formal economy. Hence, the formal/informal distinction loses meaning since all economic activities approach the character of those labeled informal. This triumph of the "invisible hand" does not lead to capitalist development, as would be anticipated from public choice theory and from de Soto's critique of the mercantilist state; the opposite is actually the case. In the absence of a stable legal framework and credible enforcement of contracts, long-term productive investment becomes impossible. Under these conditions, entrepreneurship consists of the opportunistic appropriation of rents through purchase of state privileges rather than of any long-term planning for profit. Since there is no outside arbiter of market competition, the rules become uncertain, frustrating systematic capitalist planning and the development of a modern bourgeoisie.

Man's natural propensity to "truck, barter, and exchange one thing for another," the Smithian dictum so dear to neoclassical theorists, does not in fact furnish a basis for economic development on a national scale. Someone must stand outside the competitive fray, making sure that property rules are enforced and contracts observed. Otherwise no grounds exist for predictable exchange among a myriad of anonymous actors, as it occurs in real markets. More than 40 years ago, Polanyi ([1944] 1957) argued that "natural propensities" did not create markets. Instead, "the road to the free market was opened and kept open by an enormous increase in continuous, centrally organized, and controlled interventionism" (140).

It is the intervention of the state in economic life that creates a "formal space" of predictable and enforceable transactions where modern capitalism can flourish. There is, however, a flip side to this situation well captured by Richard Adams's (1975, 69) epigram that "the more we organize society, the more resistant it becomes to our ability to organize it." A naive evolutionary view of the informal economy would depict it as dominant during an early era of weak regulation, while gradually becoming marginal and even insignificant as all facets of economic activity fall under state control. In fact, largely the opposite is the case. Since informal activities are defined precisely by their bypassing and escaping such controls, it follows that the greater the scope and reach of attempted state regulations, the more varied the opportunities to bypass them.

Lomnitz (1988, 54) states the point succinctly: "Order creates disorder. The formal economy creates its own informality." *The paradox of state control is that official efforts to obliterate unregulated activities through the proliferation of rules and controls often expand the very conditions that give rise to these activities.* The point is graphically portrayed in figure 2. Under conditions of limited state control, most economic activity is self-regulated but not informal since it does not contravene any official rule. As rules expand, opportunities to bypass them increase concomitantly until, at the limit, the

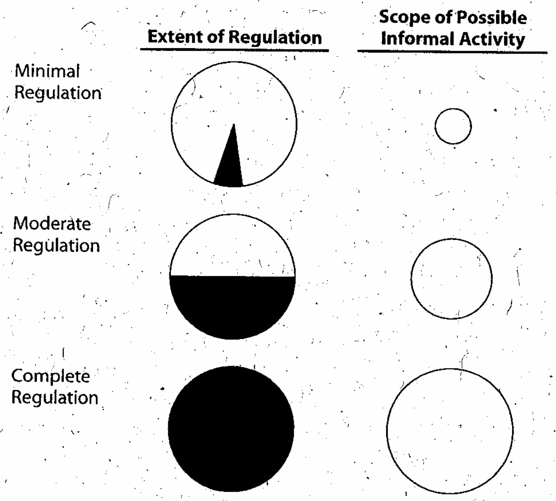

FIGURE 2. The paradox of state control: regulation and the informal economy.

entire economy is subject to the possibility of rule violation for profit. To illustrate the point with a case familiar to most readers, tax havens and tax-avoiding schemes would not exist if there were no taxation system. The more intrusive the latter, the greater the incentive and the broader the opportunities to seek redress through concealment and through various transfer ploys (Ghersi 1997; Leonard 1998).

State Capacities and Intent

The complex relationship between the state and the informal economy does not end here, however. Figure 2 makes clear that state regulation can create informality or, put differently, that the informal economy would not exist without a universe of formal, controlled activities. Yet empirical evidence indicates that the scope of the informal economy varies greatly among states with comparable formal regulations and, within nation-states, among different regions and localities. For example, the economies of northern European nations are highly regulated, but this has not produced a parallel bourgeoning informal sector, as could be predicted from figure 2 (Reenoy 1984; Dallago 1990; Leonard 1998). Similarly, rising unemployment in the old industrial cities of the U.S. Northeast did not lead to a massive informal economy organized by members of the old displaced working class. While these workers commonly engaged in casual income-earning and self-provisioning activities, the construction of complex chains of informal industrial subcontracting was beyond their reach. In the United States, these chains remained confined, for the most part, to immigrant enclaves (Waldinger 1985, 1986; Sassen 1989; Guarnizo 1994; Zhou 1992).

In the light of this and other evidence, Adams's and Lomnitz's hypothesis, summarized in figure 2, can be reformulated as predicting that the expansion of state regulation enhances the *opportunities* for engaging in irregular activities, but does not determine their actual size or form. The actual implementation of these opportunities depends on two other factors: (*a*) the state's regulatory capacity; and (*b*) the social structure and cultural resources of the population subject to these regulations. It is obvious that the capacity of official agencies to enforce the rules that they promulgate affects the extent to which informal opportunities can be implemented and the forms that they can take. It is less obvious that state strength is, in principle, independent of the set of rules that it seeks to enforce. Put differently, states with comparable regulatory capacities may assign to themselves very different "loads" of attempted control of private economic activity. The point is presented in figure 3, which distinguishes among several ideal-typical situations.

States with little enforcement capacity may be conscious of that fact and leave civil society to its own devices. This leads to a "frontier" economy where observance of commitments and regulation of economic exchanges depend on private force or traditional normative structures. Alternatively, a weak state may seek to transform this frontier economy into a more law-abiding one by promulgating a limited set of rules. This would lead naturally to a partition between an "enclave" of formal capitalism and legal enforcement of contracts and a largely self-regulated economy on the outside. This situation is typical of many Third World nations, where the formal enclave is usually limited to the capital city and its environs (Macharia 1997; Perez-Sainz 1992).

Zaire under Mobutu (as described by Evans), or the Peruvian mercantilist state (as portrayed by de Soto) can be regarded as instances of a third situation where extensive paper regulations of the economy coexist with an inept and weak state. This is the situation that favors the rise of a predatory pattern in which only a small elite benefits from state protection and resources, either controlling directly by manipulating the application of rules to the exclusion of others, or controlling indirectly, through bribed officials (Cross 1998; Bromley 1994).

State Strength	Regulatory Intent: Minimal	Limited	Total
Weak	The "Frontier" State	The "Enclave" State	The "Mercantilist" State
Strong	The Liberal State	The Social Democratic Welfare State	The Totalitarian State

FIGURE 3. State regulatory power and the extent of regulation

Strong states oscillate, in turn, between a circumspect approach to regulation of the private economy and an attempt to supplant or control its every aspect. The first type represents the laissez-faire state so dear to liberal theorists: markets operate with limited, but reliable, supervision, and the state orients its considerable resources toward other pursuits. The opposite extreme devolves into totalitarianism, as exemplified by the nations of the defunct Soviet bloc. In these situations, the state seeks to subsume civil society, provoking both widespread resistance to the rules and multiple opportunities for their violation. In between are those governments that seek an activist, but partial regulatory role for the sake of a more equitable distribution of wealth. The welfare states of Western Europe fall into this last type (Western 1998).

The Role of Civil Society

Variations in the scope of official regulations and states' differential capacity to police them interact with the characteristics of the population subject to these rules. It stands to reason that societies vary in their receptivity or resistance to official regulation and in their ability to organize underground forms of enterprise. The same variation exists among groups and communities within a specific nation-state. A population that is socialized into regular waged employment as the normal form of work, that channels demands through unions and other formal associations, and that weathers economic downturns through state-provided welfare and unemployment benefits is unlikely to organize an underground economy and is far more inclined to denounce those who engage in such activities (Roberts 1989b).

This is the case in Germany, which offers the most generous unemployment benefits in Western Europe, but has also legislated tough sentences for those engaging in off-the-books economic activities while receiving those benefits (Leonard 1998). The policy is reported to receive strong support from public opinion, which regards such "side" employment as free riding on law-abiding and taxpaying citizens. The British working class during the period of Thatcherist economic adjustment in the 1980s offers a parallel example. Despite double-digit rates of unemployment, declining wages, and widespread dissatisfaction with state policies, widespread informalization failed to emerge in Britain. Instead, those displaced from full-time formal work turned to part-time legal employment and to self-provisioning (Standing 1989).

In his study of 730 working-class and middle-class households in the island of Sheppey, Pahl found, for example, that 55 percent engaged in self-provisioning for a variety of goods and services but only 4 percent performed the same tasks for informal wages outside the home (Pahl and Wallace 1985, 212–13). Roberts (1989b, 1991) argues that a large informal economy failed to materialize in Britain despite increasingly precarious employment conditions because of the individualistic character of the welfare system, which fragments community solidarity, and to a working-class tradition that supports state control of the economy. In this context, independent efforts at informal entrepreneurship are more likely to be denounced as violations of the law than supported by neighbors and fellow workers.

At the opposite end, networked communities accustomed to relying on their own devices for survival and suspicious of official intervention are more likely to view the organization of informal enterprise as a normal part of life and involvement in the underground economy as a justifiable form of resistance. Such communities are capable of sustaining regular economic transactions in "frontier" situations where little official regulation exists (see fig. 2). This is the case of stateless or nearly stateless nations where tribal and clan solidarities occupy the place of official regulation. Somalia, a stateless country with a functioning private economy, offers a case in point (Lacey 2002). Such a self-reliant community confronts state efforts to expand and strengthen the formal sector with an awesome adversary: no matter how strong the state apparatus is, a densely networked civil society is capable of derailing and resisting official authority at every turn. The Emilian story of resistance to the dictates of the central Italian state offers another example, in an altogether different context, of the potential effects of such networks (Capecchi 1989).

It is thus necessary to supplement the typology of state regulation in figure 3 with one that incorporates the characteristics of the population subject to it. This modified ideal typology is presented in figure 4. The resulting sixfold classification highlights the point that an individualistic, atomized society "works" well only in tandem with states able to enforce limited regulation of market activity and to respond effectively to economic downturns through universalistic welfare programs. The advanced democracies of Western Europe approximate this type. In the limiting case of little state control over an atomized population, the situation would revert to a Hobbesian generalized war. At the opposite extreme of complete atomization coupled with a powerful state, we would have the basis for totalitarianism, as society lies defenseless before official power. The Soviet Union in the heyday of Stalinism approximated this type (Nove 1969; Grossman 1989).

It is difficult, however, to identify empirical instances of either extreme type because, in the absence of effective state regulation that meets basic needs of the population, the latter tends to self-organize on the basis of whatever grounds for social solidarity and normative enforcement can be found. In "frontier" situations, Hobbesian wars are commonly prevented by the emergence of unofficial hierarchies grounded on tradition and able to enforce minimum order. In the totalitarian case, the initially unchecked government power becomes increasingly contested by sectors of civil society that find grounds for solidarity and ways to bypass the omnipresent rules. The end stage of this confrontation commonly features a state economy weakened, in multiple ways, by its inability to stamp out popular initiatives, while simultaneously dependent on them. This is what happened in the former Soviet Union and its East European satellites, where the "second" economy undermined and eventually replaced the state as the true pivot of economic activity (Rev 1986; Treml 1985; Stark 1989). The current situation in Cuba, as described by local independent economists, seems to be approaching this point (Perez Roque 2002).

A logical corollary of this analysis is that the high point of formal regulation of the economy and ability to neutralize recalcitrant sectors is achieved in the midrange of limited oversight of private enterprise by a competent state apparatus. Attempts to go beyond this limit inevitably trigger resistance, reducing the very scope of control that proliferating rules seek to achieve. Figure 5 highlights the complementary point that densely networked communities are more difficult to subdue at any level of state regulation. This helps explain why organized informal subcontracting and other forms of informal enterprise in Western democracies are commonly rooted in tightly knit ethnic enclaves (Sassen 1989; Zhou 1992; Zhou and Bankston 1995). It also explains why the most effective challenges to Soviet totalitarianism were mounted by groups who, like the Georgian Jews, could rely on solidary networks and a cultural basis for norm enforcement.

To summarize, the basic paradox of state control is that increased official regulation of economic activity does not necessarily reduce the informal economy, but may expand it by creating opportunities for profitable violation of the rules. However, the extent to which these opportunities are implemented varies with the scope of attempted official control, the effectiveness of the state apparatus, and the countervailing power of society to resist or bypass official rules. A corollary of this conclusion is that efforts by strong states to stamp out all

Character of Civil Society	Extent of Regulation: Minimal	Limited	Total
Atomized (Individualistic)	Hobbesian War	Universalistic Enforcement of Rules (Western Democracies)	Stalinist Planning
Networked	Social Enforcement Structures	Competing Legal/Social Enforcement Structures	Widespread Anti-Statist Resistance

FIGURE 4. Civil society and state regulation of the economy

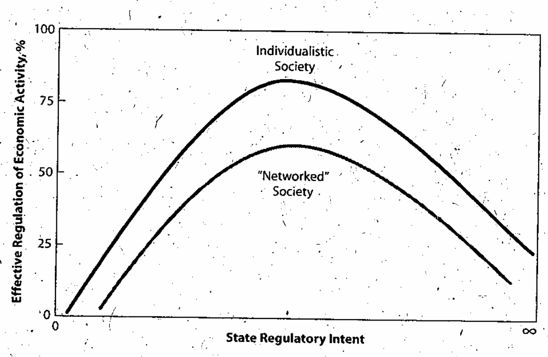

FIGURE 5. State regulatory power and the extent of regulation

traces of nonregulated economic activity seldom succeed, as they consistently activate latent sources of solidarity among the population, leading to consequences opposite to those intended.

Measuring the Unmeasurable

The Labor Market Approach

By definition, informal activities violate the law, and thus participants seek to conceal them. This makes it impossible to arrive at precise and reliable estimates of the extent of these activities or the number of people involved. The capacity of society to confront the state is nowhere clearer than in its ability to mislead taxmen, inspectors, and statisticians as to what is really taking place on the ground. This capacity gives rise to a third paradox that we will examine later in this section.

In the absence of precise measures of the informal economy, a variety of approximations have been devised. They fall into four main categories: (*a*) the labor market approach; (*b*) the small-firm approach; (*c*) the household consumption approach; (*d*) the macroeconomic discrepancy approach. Labor market approximations estimate the percentage of the total or economically active population (EAP) that works informally on the basis of specific employment categories identified in censuses or nationally representative surveys. The assumption is that certain categories of people are more prone to conceal all or some of their income-earning activities from taxing and recording authorities. The self-employed are foremost among these groups.

Presumably, as Molefsky points out (1981, 25), "the self-employed have greater opportunities to hide income and participate in the underground economy than other workers." Indeed, a study by the U.S. Internal Revenue Service, cited by this author, found that 47 percent of workers classified as independent contractors did not report any of their earnings for tax purposes (Molefsky 1981, 25). A similar rationale has led the International Labour Office (ILO) and its regional affiliates, such as the Regional Employment Program for Latin America (PREALC) to categorize the self-employed, minus professionals and technicians, as part of the informal sector.

A second suspect category is the unemployed because of the possibility that they may be working "on the side" while receiving benefits. This rationale is not plausible in Third World countries where unemployment benefits are nonexistent, but it is quite applicable in advanced countries. For the United States, economist Peter Gutmann stated flatly that "the U.S. unemployment rate, on which so much government policy depends, is substantially overstated" (1979, 22). He went on to estimate that the overcount of the unemployed was approximately 1.5 percent or approximately one million workers in 1980. In Gutmann's view, reinforced by later authors, about one in five of the officially unemployed is really a disguised informal worker or entrepreneur (Leonard 1998).

In a field study in Cleveland, MacDonald (1994) found that working while claiming benefits was "a way of life" among the poor, justified as a necessary strategy to make ends meet. Informal employment was provided by subcontractors who paid low wages for work that was often irregular. A similar pattern has been uncovered in a number of European countries. In Italy, the national statistical agency, ISTAT, estimated an irregular labor force in the construction industry numbering half a million workers in the early 1990s. These workers combine spells of unemployment, funded by state benefits, with periods of formal or informal employment. A common pattern is for construction firms to hire workers on the books for the minimum number of weeks legally required for benefits and then to dismiss them and rehire them informally through subcontractors. Similar findings have been reported in Greece and in Northern Ireland (Mingione 1990; Leonard 1994, 1998).

A fourth category is the occupationally inactive. The rationale is that those not working and not looking for work are more likely to engage in underground income-earning activities, at least on a part-time basis. Gutmann used the recorded decline in male labor force participation between 1951 and 1976 and again between 1970 and 1990 to hypothesize that many of these dropouts had actually moved to the underground economy (Gutmann 1978; Greenfield 1993). This hypothesis is open to challenge on a number of counts, including the fact that the largest and only significant declines took place among male workers aged 55 or older. Clearly, other factors such as ill health, disability, or retirement can play a major role in accounting for these figures. In other age categories, male labor force participation rates fluctuated erratically while, among females, they increased consistently and sizably for all age groups, except the oldest (Greenfield 1993, 80–81). These inconsistencies have led to the dismissal of labor force nonparticipation as a reliable indicator of informality.

TABLE 1. Estimates of the Informal Economy Based on Selected Employment Categories, 1980–98

		Employment Category			
Country[a]	*Year*	*Workers in Micro-enterprises*[b] %	*Own Account Workers*[c]	*Domestic Servants*	*Total %*[d]
Argentina	1980	10.1	32.2	3.9	46.2
	1998	15.7	19.6	4.8	40.1
Brazil	1980	10.7	19.3	7.5	37.5
	1997	9.7	25.8	8.6	44.1
Costa Rica	1981	10.0	16.7	5.5	32.2
	1998	10.6	15.4	4.8	30.8
Mexico	1984	[e]	24.7	2.6	[e]
	1998	14.9	20.5	4.1	39.5
Panama	1979	[e]	17.3	6.1	[e]
	1998	6.4	18.2	6.6	31.2
Uruguay	1981	8.8	17.7	7.5	34.0
	1998	10.6	19.9	7.2	37.7
Venezuela	1981	20.2	18.0	6.1	44.3
	1994	9.2	27.4	4.0	40.6
United States	1980	4.0	4.5	0.9	9.4
	2000	3.6	4.0	0.5	8.1
California	1980	4.0	4.5	0.8	9.3
	2000	3.3	4.3	1.0	8.6
Florida	1980	4.5	4.5	0.6	9.6
	2000	4.0	3.5	0.5	8.0
New York	1980	3.9	2.5	0.9	7.3
	2000	4.0	2.9	0.7	7.6

Source: Economic Commission for Latin America and the Caribbean (ECLAC) 2000, tables 6, 11; U.S. Bureau of the Census 1980, 2000a; 2000b.

[a] For all Latin American countries estimates are available only for the urban economically active population.
[b] As percent of the civilian economically active population aged 15 to 64.
[c] Salaried and unpaid family workers in firms employing less than 5 workers.
[d] Self-employed individuals minus professionals and technicians.
[e] No data available for this category of workers.

The ILO adds other occupational categories to the informal sector based primarily on data from less developed countries but with applications to wealthier nations as well. Domestic servants and unpaid family workers are thus classified as informal. So are workers in microenterprises that employ up to five workers on the rationale that these enterprises are either off the books or, if registered, commonly fail to observe legal rules in their hiring practices (Perez-Sainz 1992; Klein and Tokman 2000). Based on these employment categories, as recorded in national household surveys, UN agencies can provide estimates of the informal labor force for most countries. Table 1 presents these estimates for selected Latin American countries and their evolution during the last two decades ending in 2000. For comparative purposes, figures for the United States and for three major states are also presented.

The 1980s and 1990s are generally regarded as a period of severe economic adjustment in Latin America following the regional debt-induced crisis in the wake of the Mexican default of 1982 (Klein and Tokman 2000; Portes 1997). Despite major economic policy changes during this period, the proportion of the economically active population (EAP) estimated to be informally employed barely budged. The figure fluctuated between 30 and 45 percent of the EAP across countries, and changes during these years were small and did not follow a consistent pattern. The corresponding figures for the United States are much lower, representing less than 10 percent of the adult civilian population. Even this small proportion declined marginally during the last decades. To see if there were significant regional variations in these estimates, we examined the series for California, Florida, and New York—states where rising informal activities associated with mass immigration have been reported (Sassen 1989; Lozano 1989). As shown in table 1, the state-level series follow closely the national pattern and provide no evidence of a significant rise in informal employment anywhere.[2] According to these figures, informal employment represents a phenomenon of limited significance in the United States involving less than one decile of its labor force.

The Small-Firm and Household Consumption Approaches

A second, related method is based on the evolution of the number and proportion of "very small enterprises" (VSEs) as an indicator of change in informal activities. VSEs are defined as those employing fewer than 10 workers. This approach has been applied in the United States in lieu of labor market data. The assumption is that, in advanced countries, most activities defined as informal occur in smaller enterprises because of their lesser visibility, greater flexibility, and greater opportunities to escape state controls. Larger firms are assumed to be more vulnerable to state regulation and more risk-averse to potential penalties. Hence, they are less likely to engage in informal activities directly, although they can subcontract work to smaller firms that do (Portes and Sassen 1987; Sassen and Smith 1992).

The idea for this approach came from interviews with officials of the Wage and Hour Division of the U.S. Department of Labor, the agency charged with enforcing minimum wage, overtime, and other protective codes for American workers. The interviews indicated widespread violations of the labor codes among garment, electronics, and construction subcontractors as well as in all kinds of personal and household services, especially in large metropolitan areas. Most of the enterprises involved were small, employing fewer than 10 workers (Fernández-Kelly and Garcia 1989; Sassen and Smith 1992). A separate study by the General Accounting Office identified the restaurant, apparel, and meat-processing industries—all sectors where small firms predominate—as having the greatest incidence of "sweatshop practices." Included in this category were failure to keep records of wages and work hours, wages below the legal minimum or without overtime pay, employment of minors, fire hazards, and other unsafe work conditions (General Accounting Office 1989).

As an indicator of the extent of informality, the evolution of VSEs is subject to two contrary biases. First, not all small firms engage in informal practices, which leads to an overestimate; second, fully informal VSEs escape all government recordkeeping, which leads to underestimation. The extent to which these biases neutralize each other is not known. In this situation, the statistical series are best interpreted as a rough estimate of the evolution of the informal sector on the basis of those recorded firms that most closely approximate it.

Table 2 presents the proportion of VSEs and their employees in the country as a whole during the period 1965–99. Also included is the propor-

TABLE 2. Number of Units and Employment in Very Small Establishments (VSEs) in the United States, 1965–99

	United States		*California*			*Florida*			*New York*		
Year	*Firms (%)*	*Employees (%)*	*Firms (%)*	*Employees (%)*	*San Diego County Firms (%)*	*Firms (%)*	*Employees (%)*	*Dade County Firms (%)*	*Firms (%)*	*Employees (%)*	*Queens County Firms (%)*
1965	76.0	14.1	75.1	14.7	76.9	75.2	17.4	70.8	75.2	13.1	77.0
	(3.5)	(47.7)	(0.34)	(4.5)	(0.12)	(1.3)			(0.38)	(5.4)	
1970	70.6	11.9	71.0	12.4	71.2	70.5	14.1	66.7	71.8	11.2	74.8
1975	77.2	16.3	77.0	17.0	78.4	77.8	20.0	77.1	78.9	15.5	80.2
1980	74.1	15.2	73.5	15.2	74.9	75.7	18.7	74.4	76.5	14.8	78.5
1985	75.9	15.8	75.3	15.2	76.2	77.7	18.7	78.6	77.9	14.8	79.7
1990	74.2	15.0	73.4	14.4	73.6	76.6	18.0	78.4	76.9	14.5	79.7
1995	74.3	14.7	74.1	14.6	74.9	77.3	17.1	79.3	77.6	14.8	81.0
1999	73.6	14.0	72.9	13.5	72.9	77.3	15.5	79.6	77.1	14.6	80.6
	(7.1)	(110.7)	(0.78)	(12.3)	(0.07)	(0.42)	(5.9)	(0.07)	(0.49)	(7.1)	(0.04)

Source: U.S. Bureau of the Census, 1965–2000.

Note: VSEs are defined as establishments employing fewer than 10 workers. Figures in parentheses are absolute numbers, in millions.

tion of these units and their employees in the states of New York, Florida, and California and of establishments in the counties of Queens, New York; Dade, Florida; and San Diego, California. As mentioned previously, these are the sites of recent studies that describe the growth of informal activities primarily associated with a rapid rise in immigration. Number of employees broken down by size and class of establishment is not available for counties in the census data.

About three-fourths of U.S. establishments counted by the census were VSEs in 1965, and they absorbed approximately one-seventh of the economically active population. By 1985, the figures were almost exactly the same, although the variations along the way are instructive. Between 1965 and 1970, there was a 6 percent decline in the proportion of VSEs and a 2 percent drop in the proportion of the labor force employed by them. The reversal of this trend between 1970 and 1975 is an artifact of the small size-class of establishment reported by the census—from fewer than eight to fewer than 10 employees. Thereafter and until 1980, there was again a gradual decline, but, in that year, the trend reversed once more with the proportion of VSEs in 1985 reaching the same level as in 1965. After 1985, there has been a new slow decline in the relative number of VSEs and the proportion of the labor force employed by them.

State figures follow a similar pattern except that, by 1985, VSEs were more common in Florida and New York than in the country as a whole. Thereafter, the figures declined in California, where the relative number of VSEs dropped below the national average by 1989, while in Florida and New York it remained significantly above. The three county series show a similar evolution, but, in each instance, the proportion of VSEs was larger than in the respective state in 1985 and in the cases of Dade (Miami) and Queens (New York) much higher than the national average. Thereafter, the county and state figures converged for California, while Queens County and Dade County continued to report consistently larger proportions of VSEs than their respective states and the nation. This result is in line with ethnographic studies that report a high incidence of small firms and informal activities in these urban areas (Sassen 1989; Stepick 1989; Guarnizo, Sanchez, and Roach 1999). Contrary to the labor market approach, we do find significant regional variations in the presence of the firms most closely associated with the informal economy.

The third approach, the household consumption method, is based on the recognition that direct survey measures of informal employment are difficult to obtain in developed countries. For this reason, James Smith and his associates (Smith 1987; McCrohan, Smith, and Adams 1991) developed an ingenious method based on the consumption of informally provided goods and services by American households. The studies were based on national probability surveys conducted by the Survey Research Center of the University of Michigan in 1981, 1985, and 1986. Informal activity was defined as market transactions that should be recorded or taxed but were not. Respondents were asked to report the amounts spent over the preceding year on goods and services acquired off the books or on the side. On the basis of these results, the authors estimated that U.S. households spent a maximum of $72.4 billion in informal purchases, representing 14.6 percent of all expenditures (formal and informal) in 1985. The study also reported that fully 83 percent of all American households made use of at least one type of informal supplier. Home repairs and improvements topped the list in terms of dollars spent followed by food purchases, child care, other personal and domestic services, and auto repairs (McCrohan, Smith, and Adams 1991, 37).

This method has the merit of relying on direct and statistically representative survey measures and hence yielding an authoritative estimate of household consumption. As an indicator of the scope of informality in the national economy, it suffers the fatal flaw of neglecting informally produced inputs for larger firms and irregular labor practices within them. In other words, the entire universe of informal subcontracting in the apparel, electronics, furniture, construction, and many other industries as well as off-the-books employment by formal enterprises is precluded by a measurement approach focused exclusively on final household consumption. This method shares with the VSEs approach the key assumption that informality is found predominantly in the smallest economic units. However, in both cases, there is considerable slippage between what actually happens and what the numbers can tell us.

Macroeconomic Estimates

The fourth strategy, the macroeconomic discrepancy method, attempts to measure the magnitude of the total underground economy as a proportion of the gross national product (GNP). This method is based on the existence of at least two different but comparable measures of some aspect of a national economy. Discrepancies between these measurements are then attributed to underground activities. For example, gaps in the income and expenditure side of national accounts can be used to estimate the size of unreported income to the extent that individuals can be assumed to be less likely to misrepresent their expenditures than to misrepresent their incomes (Feige 1990). These methods have been more popular in the advanced countries, where government record-keeping and national accounts are better developed and where the probability of obtaining valid reports on individual participation in underground activities through survey questions is low. The more elaborate of these estimating methods, based on the ratio of currency in circulation to demand deposits, was pioneered by Gutmann (1977, 1979) and subsequently modified by Feige (1979) and Tanzi (1980, 1983). Their "currency ratio" approach is based on the assumption that informal transactions are conducted mostly in cash in order to avoid detection by fiscal authorities.

The approach consists of arriving at an estimate of the currency in circulation required by the operation of legal activities and subtracting this figure from the actual monetary mass. The difference, multiplied by the velocity of money, provides an estimate of the magnitude of the underground economy. The ratio of that figure to the observed GNP then gives the proportion of the national economy represented by subterranean activities. The method depends on the identification of a base period in which the underground economy was assumed to be insignificant. The ratio of currency in circulation to the reference figures (demand deposits for Gutmann; GNP for Feige; M2 for Tanzi) is established for this period and then extrapolated to the present. The difference between this estimate and the actual ratio provides the basis for calculating the magnitude of underground activities. Using this approach, Feige (1990, 997) reported that the U.S. underground economy as a proportion of total reported adjusted gross income (AGI) rose from 0 in 1940 (the base year) to 20 percent in 1945, declined subsequently to about 6 percent in 1960, increased rapidly to reach 24 percent in 1983, and then declined again to about 18 percent in 1986. Despite the differences in measurement procedures, this evolution corresponds fairly well, during the period 1965–89, with that based on the relative number of VSEs, reported in table 2.

More recently, Feige (1997) noted that earlier calculations had been grossly distorted by the failure to take into account currency that left the United States to serve as a deposit of value or a means of exchange in other countries. According to his calculations, up to 80 percent of U.S. currency is unaccounted for, and much of it is held abroad. After a series of complex calculations, Feige concludes that unreported income in the United States was approximately $700 billion in 1991 and not the over $1 trillion estimated with unadjusted models. Even after this adjustment, the size of the unreported economy reached again 25 percent of reported AGI in 1990–91 (Feige 1997, 201).

Macroeconomic methods for estimating the size of the underground economy through unreported income have been increasingly used by economists in other countries. In Canada, for example, various researchers utilizing these methods arrived at figures ranging from 2.8 percent of GDP in 1981 (reported by Statistics Canada) to 14.1 percent (reported by Mirus using Tanzi's approach). Ten years later, Gutmann's method, as applied by Karoleff, Mirus, and Smith (1993), yielded an estimate of 21.6 percent of GDP, but the figure from Statistics Canada remained at 2.7 percent (Smith 1997, table 3).

The macroeconomic procedures have serious weaknesses that have been noted by a number of analysts (Feige 1990; Portes and Sassen 1987). First, the assumption that informal transactions take place mostly in cash is questionable in settings where bank checks and other instruments can be used with little fear of detection by the authorities. Second, the assumption that informal activities did not exist in some arbitrarily designated period is also subject to question. Third, and most important, these estimates do not differentiate between illegal and informal activities. As seen above, informal activities involve goods and services that are otherwise licit, but whose production or distribution bypasses official channels. Hence, the huge estimates of the subterranean economy sometimes reached through these methods can be due to the presence of a large criminal underground whose operation and character are quite different from those of the informal economy proper.

Finally, estimates based on these macroeconomic methods vary widely according to the assumptions and figures employed. Porter and Bayer (1984) replicated the methods used by Gutmann, Feige, and Tanzi to obtain estimates of the absolute and relative size of the U.S. underground economy between 1950 and 1980. Their results

TABLE 3. Estimates of the U.S. Underground Economy according to Macroeconomic Discrepancy Methods

Year	*Guttmann*		*Tanzi*		*Feige*	
	Billions $	*% of GNP*	*Billions $*	*% of GNP*	*Billions $*	*% of GNP*
1950	15.9	5.6	14.5	5.1	27.6	9.6
1955	14.7	3.7	12.8	3.2	1.7	0.4
1960	17.3	3.4	20.7	4.1	−3.4	−0.7
1965	31.6	4.6	26.3	3.8	9.6	1.4
1970	62.4	6.3	45.6	4.6	101.0	10.2
1975	150.8	9.7	77.0	5.0	467.3	30.2
1979	317.8	13.1	130.7	5.4	628.4	26.0
1980	372.8	14.2	159.9	6.1	1,095.6	41.6

Source: Porter and Bayer 1984, 178.

are reproduced in table 3. The three sets of estimates vary widely. In 1980, for example, Guttmann's method (as applied by Porter and Bayer) yielded an estimate of the underground economy of 14 percent of the GNP; Tanzi's approach reduced the figure to 6 percent, while Feige's method increased it to 42 percent. Similar discrepancies are found in estimates for other countries such as Canada, Great Britain (Burton 1997), Germany (Enste and Schneider 1998), and Mexico (CEESP 1987).

The Measurement Paradox

The limitations of all existing methods of measurement stem from the nature of the phenomenon they attempt to gauge, which is elusive by definition. However, the extent to which informal activities are concealed is not uniform. There are levels of concealment depending on the character of state regulation and the effectiveness of its enforcement. In settings where the informal economy is widespread and semiopen, as in many Third World countries and several Eastern European nations, it is possible to arrive at reliable estimates of its size on the basis of direct surveys. Lax enforcement and the generalized character of these activities make informal owners and workers less apprehensive about answering questions about their work. In Latin America several surveys have produced acceptable estimates of the size of the labor force employed by the informal sector in several metropolitan areas (Carbonetto, Hoyle, and Tueros 1985; Lanzetta de Pardo and Murillo Castano 1989; Roberts 1992).

When state regulation is both highly effective and extensive, as in many industrialized countries, the situation changes. In these instances, informal activities are better concealed and, as we have seen, generally embedded in tighter social networks. Hence, no matter how well organized the official record-keeping apparatus is, it is likely to miss a significant amount of informal activity. In the United States, for instance, analysts have long discounted the possibility of measuring the informal or underground economy through direct survey questions and hence are forced to rely on the approximate methods described earlier. Despite the progressive weakening of the Wage and Hour Division and other enforcement agencies since the Reagan administration in the 1980s, informal workers and entrepreneurs are still reluctant to talk about their work (Fernández-Kelly and Garcia 1989). The measurement alternatives, from household consumption patterns to macroeconomic discrepancy ratios, have yielded estimates too feeble to guide either theory or policy.

The third paradox of the informal economy is that the more credible the state enforcement apparatus is, the more likely its record-keeping mechanisms will miss the actual extent of the informal economy and, hence, the feebler the basis for developing policies to address it. If Feige's estimates are taken at face value, an entire quarter of all economic activity in the United States took place outside the pale of state regulation in the early 1990s. Since the government knows little about the character and scope of these practices, it proceeds as if, in effect, they did not exist. The assumption can lead to serious policy consequences.

> To the extent that national accounting systems are based on data sources primarily collected from the formal sector, a large and growing informal economy will play havoc with perceptions of development based on official statistics, and consequently with policy decisions based exclusively on information provided by official sources. (Feige 1990, 993)

This statement must be qualified, however, by the previous discussion concerning the extent of state enforcement and the character of the civil society subject to it. As shown in figures 4 and 5, the informal economy is likely to be weakest when limited regulation of economic activity by a competent state apparatus is coupled with a population accustomed to regular waged employment and to legal avenues for demand-making and redress of grievances. In these situations, working "on the side" or "off the books" is likely to meet with disapproval, leading to a situation in which society itself, and not only the state, becomes an enforcer of legal rules. Informal enterprise in these contexts is limited to fringe sectors, and the bulk of the "unreported economy" is probably accounted for by criminal, not informal, activities.

At the other extreme, the capacity of civil society to resist complete absorption by an authoritarian state is nowhere clearer than in its withdrawal of information from state record-keeping agencies. The best example of the third paradox is provided by the now-defunct Eastern European command economies. There, state policies aimed at controlling every aspect of economic activity required vast amounts of information in order to function properly. However, the same policies gave rise to a vast underground economy whose existence depended precisely on escaping official detection. The result was that the information on which state managers had to rely became progressively illusory and the subsequent policies unrealistic (Burawoy and Lukács 1985; Stark 1989; Rev 1986). Firms and state agencies in the "first" economy became trapped in a make-believe world, feeding each other's misperceptions and operating at an ever-growing distance from the real world. The outcome is well known.

Conclusion: The Changing Boundaries of Informality

Reprise

In this chapter, we have reviewed various definitions of the informal economy, distinguished it from criminal and underground activities, and explored some of its peculiar characteristics. From the definition of the phenomenon used in the analysis, it is clear that the elements composing the informal sector vary across countries and over time. The relationship between the state and civil society defines the character of informality, and this relationship is in constant flux. The changing geometry of formal/informal economic activities follows the contours delineated by past history and the nature of state authority. There is thus no great mystery in the diversity of formal-informal interactions reported in the literature. Every concrete situation has in common the existence of economic practices that violate or bypass state regulation, but what these are varies according to state-society relations. Hence, what is informal and persecuted in one setting may be perfectly legal in another; the same activity may shift its location across the formal-informal divide over time. Lastly, the very notion of informality may become irrelevant in cases where the state abdicates its regulatory role.

The informal economy may be characterized as a constructed response by civil society to unwanted state interference. The universal character of the phenomenon reflects the considerable capacity of resistance in most societies to the exercise of state power. An activity can be made illegal without disappearing; entire economic sectors may be legislated out of existence yet still flourish underground. The universality of the informal economy is confirmed by a burgeoning research literature that describes its characteristics and consequences in settings as diverse as Canada, California, the Netherlands, Mexico, Jordan, and South Africa (Smith 1997; Lozano 1989; Lomnitz 1977, 1988; Doan 1992; McKeever 1998).

This literature also illustrates the diverse functionality of informal activities for the actors involved. While a good portion of this literature, coming from economics, views the phenomenon as tax evasion (Spiro 1997), detailed field studies take a more nuanced view. It is obvious that informal enterprise is "functional" for those so employed in terms of providing a minimum means of survival. It is equally obvious that the formal firms that subcontract production and marketing to informal entrepreneurs or who hire workers off the books benefit from the higher flexibility and lower costs thus obtained. It is less evident, however, that the informal economy can also have positive consequences for the very actor whose existence and logic it challenges.

A Final Paradox

The fourth paradox of the informal economy is that it commonly yields a series of positive effects for the state, the very institution charged with it suppression. This paradox also adopts different forms depending on national context. In less developed countries, where protective labor legislation often runs way ahead of the capacity of the formal economy to provide full employment, informal enterprise has a double function. First, it employs and provides incomes to a large segment of the population that otherwise would be deprived on any means of subsistence. The "cushion" provided by the informal economy can make all the difference between relative tranquility and political upheavals in these nations (Meagher 1995; Cheng and Gereffi 1994; Diaz 1993).

Second, the goods and services provided by informal producers lower the costs of consumption for formal workers and the costs of production and distribution for formal firms, thus contributing to their viability (Portes and Walton 1981). The low wages received by formal sector employees in Third World nations are partially compensated for by the greater acquisitive power of these wages through informally produced goods and services. In turn, large firms can compensate for costly tax and labor codes by restricting the size of their formally employed labor force and subcontracting the rest to informal entrepreneurs. Through these mechanisms, the informal economy contributes to the political stability and economic viability of poorer nations. These realities help explain why informal activities are commonly tolerated by many governments, in contradiction to their law-enforcement duties (Cross 2000; Kempe 1993; Birbeck 1978).

In the advanced countries, the cushioning function of informality is also present, especially in relation to marginal segments of the population. When for political or economic reasons, unemployment and other state-provided benefits are meager, recipients compensate by finding additional sources of income, commonly through informal employment. This gives rise to the situation reported by MacDonald (1994) in Cincinnati, where combining welfare with off-the-books casual jobs becomes a "way of life" for minority workers in the inner city. While such arrangements are regularly condemned by the media and by government officials, conveniently forgotten is the fact that these casual jobs make possible the perpetuation of a low-cost social welfare system bearing little relation to the actual cost of living (Uehara 1990; Fernández-Kelly 1995; Edin and Lein 1997).

Informality can also provide a protective environment for fledgling, but innovative, forms of entrepreneurship. The Italian case again offers the best example. Though the government in Rome took a dim view of what was taking place in Emilia Romagna, the informal networks of cooperation and solidarity among Emilian artisans eventually gave rise to a system of flexible specialization that became a world model (Capecchi 1989). This is not the sole example of this "incubator" function, as the experiences of Silicon Valley firms, started in owners' garages and basements, attest (Lozano 1989). For fledgling but viable entrepreneurial ventures, the informal economy can operate as a protective environment sparing them from burdensome and costly regulations that can prematurely sink them or compromise their growth. As firms mature, they enter the formal economy, contributing to its growth. This is what happened in central Italy, in Silicon Valley, and elsewhere.

The various functions of the informal economy may help explain why governments in both advanced and less developed countries often adopt an ambiguous attitude toward these activities, tolerating their existence at least on a temporary basis. Too much tolerance would compromise the credibility of the rule of law and the willingness of formal firms and taxpayers to continue shouldering their obligations. On the other hand, too repressive a stance would do away with the "cushion" provided by informal activities or, what is worse, drive them further underground, depriving authorities of any information or control on them. The systematic withdrawal of information from government agents has proven by far the most effective tool in the hands of civil society to resist authoritarian rule.

The complex relationships between the state and the informal economy and the multiple forms adopted by the latter rule out an approach to this phenomenon based on a simple tax-evasion perspective. The analytic stance to study these phenomena must be as nuanced and flexible as they have proven to be, combining the use of aggregate statistics and large surveys with careful firsthand investigation. Only in this manner can we approach with some success the elusive world of informality and learn from its complex character.

Notes

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1. The first version of this chapter, published in the first edition of this *Handbook*, discussed the first three paradoxes, but omitted the fourth. We examine it in the concluding section. The analysis of the second paradox has also been substantially modified from its earlier treatment, which we

now feel was incomplete. The review of various estimation approaches to measure the informal economy in the United States and other countries has been expanded, with new figures provided.

2. Figures presented in table 3 are not strictly comparable because the series for Latin America are limited to urban areas. The bias introduced by this limitation is conservative since it reduces the magnitude of the observed differences between the United States and Latin America. The reason is that the proportion of the rural labor force employed informally is higher than in urban areas in all countries of the region.

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