

## **Explaining the Informal Economy: an Exploratory Evaluation of Competing Perspectives**

### **Expliquer l'économie informelle : évaluation exploratoire de perspectives concurrentielles**

### **Explicar la economía informal: una evaluación exploratoria de las perspectivas concurrentes**

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#### **Article abstract**

The aim of this paper is to conduct an exploratory analysis of the wider economic and social conditions associated with larger informal economies. To do this, three competing perspectives are evaluated critically which variously assert that cross-national variations in the size of the informal economy are associated with: under-development (modernization perspective); high taxes, corruption and state interference (neo-liberal perspective), or inadequate state intervention to protect workers (political economy perspective). Analyzing the variable size of the informal economy across 33 developed and transition economies, namely 28 European countries and five other OECD nations (Australia, Canada, Japan, New Zealand and the USA), the finding is that larger informal economies are associated with under-development as measured by lower levels of GNI per capita, employment participation rates, average wages and the institutional strength and quality of the bureaucracy, higher levels of perceived public sector corruption, lower levels of expenditure on social protection and labour market intervention to protect vulnerable groups, but also restrictions on the use of temporary employment contracts and TWAs. The outcome is a tentative call to combine a range of tenets from all three perspectives in a new more nuanced and finer-grained understanding of how the cross-national variations in the size of the informal economy are associated with broader economic and social conditions. The paper concludes by discussing the implications for theory and policy, including the need for further analysis of the different impacts on the size of the informal economy of a wider range of indicators of modernization, corruption, taxation and types of state intervention.

# Explaining the Informal Economy: an Exploratory Evaluation of Competing Perspectives

Colin C. Williams

**This paper evaluates critically whether the cross-national variations in the size of the informal economy are the result of: under-development (a modernization perspective); high taxes, corruption and state interference (neo-liberal perspective); or inadequate state intervention to protect workers (political economy perspective). Analyzing the varying size of the informal economy across 33 developed and transition economies, elements of all three perspectives are found to be valid with larger informal economies associated with under-development, public sector corruption and over-regulation in some spheres (e.g., temporary employment and temporary work agencies) but too little intervention in others (e.g., social protection, labour market interventions to protect vulnerable groups). The implications for theory and policy are then discussed.**

**KEYWORDS: informal sector, undeclared work, employment relations, economic development, developed countries.**

## Introduction

The starting point of this paper is a recognition that the size of the informal economy varies across countries and that competing explanations have emerged which variously posit that larger informal economies are the result of either economic under-development (modernization perspective), corruption, high taxes and state interference (neo-liberal perspective) or inadequate state intervention to protect workers from poverty (political economy perspective). The aim of this paper is to evaluate critically these competing views by conducting an exploratory analysis of how the prevalence of the informal economy varies across different work and welfare regimes.

To do this, the first section will briefly review these competing views and reveal that most studies have adopted one or other perspective to explain cross-national variations in the size of the informal economy. Few studies have sought to synthesize these views by combining tenets from different perspectives and none have so far sought to develop a finer-grained understanding of the

varying impacts of, for example, different taxation measures and types of state intervention. To start filling this gap, the second section outlines the methodology and range of indicators used to evaluate critically these competing explanations for the cross-national variations in the size of the informal economy in developed and transition economies, namely 28 European Union member states (EU-28) and five high-income OECD countries (Australia, Canada, Japan, New Zealand and the USA). The third section then reports the findings. Finding that various tenets of all three perspectives are valid, a tentative call is made to view larger informal economies as associated with economic under-development and public sector corruption and to pursue a nuanced understanding of the varying roles played by different forms of state intervention by recognizing that larger informal economies could result from over-regulation in some spheres (e.g., temporary employment and temporary work agencies) but too little intervention to protect workers in others (e.g., social protection, labour market interventions to protect vulnerable groups). The paper concludes by discussing the theoretical and policy implications of these findings.

However, first, the informal economy needs to be defined. All definitions denote what is lacking, insufficient or absent about the informal economy relative to the formal economy and are of three broad types, namely enterprise-, jobs- and activity-based definitions. In developing countries, definitions are more commonly enterprise- and jobs-based denoting what is missing or absent from informal relative to formal enterprises and jobs (Husmanns, 2005; ILO, 2012). In developed countries and transition economies however, which is the focus of this paper, official definitions are more commonly activity-based (European Commission, 1998, 2007a,b, 2014; OECD, 2012). The most frequently adopted is the activity-based definition published in 2002 by the Organisation for Economic Cooperation and Development (OECD), International Monetary Fund (IMF), International Labour Organization (ILO) and Interstate Statistical Committee of the Commonwealth of Independent States (CIS STAT) as a supplement to the System of National Accounts (SNA) 1993. This defines the informal sphere as:

[...] all legal production activities that are deliberately concealed from public authorities for the following kinds of reasons: to avoid payment of income, value added or other taxes; to avoid payment of social security contributions; to avoid having to meet certain legal standards such as minimum wages, maximum hours, safety or health standards, etc. (OECD, 2002: 139).

It is this activity-based definition which is adopted in this paper. If other absences or insufficiencies prevail, therefore, such as the activities are illegal or the work is not paid, this activity is not part of the informal economy but instead part of the separate "criminal" or "unpaid" spheres. Blurred edges, nevertheless, remain such as when gifts are provided in lieu of money or in-kind labour is

exchanged (White, 2009; White and Williams, 2010). In this paper, however, the informal economy includes only activities involving monetary transactions between the employer/purchaser and employee/supplier.

## Perspectives towards the informal economy

To explain the cross-national variations in the size of the informal economy, three contrasting explanations have been proposed: the «modernization» perspective which purports that the informal economy decreases as economies modernize and develop; the “neo-liberal” perspective that its prevalence is a direct result of high taxes, public sector corruption and state interference in the free market, and the “political economy” perspective that its pervasiveness is the outcome of inadequate levels of state intervention in work and welfare which leaves workers unprotected. Each is here considered in turn.

### Modernization perspective

Over the course of the twentieth century, a widespread belief was that the formal economy was steadily expanding and that the informal economy was a remnant of some pre-modern era that was gradually vanishing as the modern formal economy became ever more dominant. Seen through this lens, the informal economy therefore constitutes a pre-modern traditional sector that persists at the fringes of modern society and represents «traditionalism,» «under-development» and «backwardness» whilst the emerging modern formal economy signals «progress,» «advancement» and «development» (Geertz, 1963; Lewis, 1959; La Porta and Schleifer, 2008, 2014). As modernization occurs and the formal economy takes hold, this sphere is viewed as disappearing. When explaining the cross-national variations in the size of the informal economy, the view is that it prevails in less developed and less modern economies, measured using indicators such as GDP per capita, employment participation rates (as a proxy for formalization), average wages and the quality of the modern bureaucratic state apparatus. To explore the validity of this modernization perspective, the following hypothesis can be tested:

**MODERNIZATION HYPOTHESIS (H1):** the informal economy will be larger in less developed modern economies.

### Neo-liberal perspective

For a group of neo-liberal scholars, participation in the informal economy is a matter of choice and a rational economic response to high taxes, public sector corruption and a burdensome and excessively intrusive state (Becker, 2004; De Soto, 1989, 2001; London and Hart, 2004; Nwabuzor, 2005; Sauvy, 1984; Schneider

and Williams, 2013). Informal workers thus voluntarily operate informally to avoid the costs, time and effort of formal registration (de Soto, 1989, 2001; Perry and Maloney, 2007; Small Business Council, 2004). As Nwabuzor (2005: 126) asserts, "Informality is a response to burdensome controls, and an attempt to circumvent them," or as Becker (2004: 10) puts it, "informal work arrangements are a rational response by micro-entrepreneurs to over-regulation by government bureaucracies." For De Soto (1989: 255) in consequence, "the real problem is not so much informality as formality." Seen through this lens, the size of the informal economy will be greater in economies with higher taxes, public sector corruption and greater state interference (de Soto, 1989, 2001; Perry and Maloney, 2007; Small Business Council, 2004) and the resultant solution is to reduce taxes, tackle public sector corruption and pursue minimal state intervention. To explore the validity of this neo-liberal perspective, the following hypothesis can be tested:

**NEO-LIBERAL HYPOTHESIS (H2):** the informal economy will be larger in countries with higher tax rates, greater public sector corruption and higher levels of state interference in the free market.

### **Political economy perspective**

In stark contrast to the neo-liberal perspective, a political economy perspective views the informal economy to be a product of too little rather than too much state intervention in work and welfare arrangements. This perspective represents the informal economy as embedded in current capitalist production practices and an integral component of the new downsizing, sub-contracting and outsourcing practices emerging under deregulated global capitalism since the informal economy provides organizations with a channel to attain flexible production, profit and cost reduction (Castells and Portes, 1989; Davis, 2006; Gallin, 2001; Sassen, 1996; Slavnic, 2010; Taiwo, 2013). Seen in this manner, in the current era of deregulated global capitalism, the full-employment and comprehensive formal welfare state regime which characterized Fordist and socialist work and welfare regimes has been replaced with a new post-Fordist and post-socialist work and welfare regime of deregulation, liberalization and privatization (Castells and Portes, 1989; Meagher, 2010; Sassen, 1996) which through subcontracting, outsourcing and diminishing state involvement in welfare and employment is moving the informal economy to the centre of contemporary economies.

Informal work is consequently portrayed as a form of unregulated, low paid and insecure work conducted by populations marginalized from the formal economy who conduct such endeavour out of necessity as a survival tactic in the absence of alternative means of livelihood (Ahmad, 2008; Castells and Portes, 1989; Davis, 2006; Gallin, 2001; Sassen, 1996). Viewed through this political economy lens, the informal economy is thus a result of a lack of intervention in work

and welfare provision (e.g., social protection, social transfers and labour market interventions to protect vulnerable groups) and the remedy is greater intervention in work and welfare arrangements (Davis, 2006; Slavnic, 2010; Taiwo, 2013). Consequently, the informal economy will be greater in countries with lower levels of state intervention in work and welfare arrangements to protect workers from poverty (Davis, 2006; Gallin, 2001; Slavnic, 2010). To evaluate the validity of this political economy perspective, the following hypothesis can be tested:

**POLITICAL ECONOMY HYPOTHESIS (H3):** the informal economy will be larger in countries where there is a lack of labour market intervention and social protection.

### **Evaluations of the rival perspectives**

Conventionally, most commentators explaining the greater size of the informal economy in some populations rather than others have adopted one or other of these competing perspectives. For example, Yamada (1996) adopts the neo-liberal view arguing that participation in the informal economy is a matter of choice and product of too much intervention whilst Slavnic (2010) adopts the political economy perspective that it is due to a lack of choice and a result of too little intervention in work and welfare arrangements.

In recent years, nevertheless, a small but burgeoning literature has sought to combine these perspectives when explaining the informal economy at a national or local level. It has been contested for instance that the political economy perspective explains the informal economy in relatively deprived population groups and neo-liberal perspective in relatively affluent population groups (Gurtoo and Williams, 2009; Williams and Round, 2010; Williams *et al.*, 2013), that neo-liberal explanations are more relevant to developed economies and political economy explanations to developing economies (Oviedo *et al.*, 2009) and that women are driven more by political economy exclusion motives and men more by neo-liberal voluntary exit motives (Franck, 2012; Grant, 2013; Williams, 2011).

When explaining cross-national variations in the size of the informal economy, nevertheless, commentators have predominantly adhered to one or other explanation. For example, the ILO (2012) tentatively advocate the modernization view whilst a range of commentators comparing the 27 member states of the European Union (EU-27) have refuted the neo-liberal view that high tax rates and intervention in work and welfare arrangements increase the size of the informal economy and instead supported the political economy perspective that greater levels of expenditure on social protection and labour market interventions to protect vulnerable groups reduce the size of the informal economy (Eurofound, 2014; Vanderseypen *et al.*, 2013; Williams, 2013a, 2014). Although one recent study of the EU-27 calls for the tenets of the modernization perspective and the corruption te-

net of the neo-liberal view to be added to the political economy perspective when explaining cross-national variations in the size of the informal economy (Williams, 2013b), this continues to largely adhere to the political economy perspective that smaller informal economies result from higher tax rates and greater state intervention in work and welfare arrangements. Beyond this notable exception, studies have not sought to synthesize these perspectives by combining tenets from different views and no studies have so far sought to investigate whether for example different forms of taxation and varying types of state intervention in work and welfare arrangements have different impacts on the size of the informal economy in order to develop a finer-grained and more nuanced synthesis of these different perspectives. The intention here is to tentatively start to fill that gap.

## Methodology

The difficulty one immediately confronts when measuring the size of the informal economy is that this remunerated activity is by definition hidden from view. The result is that there has been a tendency to adopt indirect measurement methods which use proxy indicators and/or statistical traces of such work found in data collected for other purposes. The proxies used range from monetary indicators, such as the currency demand method which uses cash in circulation as an indicator of informality, through non-monetary indicators such as discrepancies in the labour supply figures across different surveys to the use of discrepancies between income and expenditure either at the aggregate or household level (GHK and Fondazione Brodolini, 2009; Ram and Williams, 2008). In this paper, however, the most widely used indirect measurement method is used to estimate the cross-national variations in the size of the informal economy, namely the DYMIMIC (dynamic multiple-indicators multiple-causes) method. This approach takes the informal economy as an unobserved (latent) variable and rather than rely on one indicator to measure its size, uses multiple monetary and non-monetary indicators related to the money in circulation, level of tax morality and labour supply (for a detailed description of how this method calculates the size of the informal economy, see Schneider, 2005). Nevertheless, and akin to all other methods of measuring the informal economy, it should be noted that this method has been subject to criticism. In the case of this method, these criticisms relate mainly to the validity of the variables used (Breusch, 2005). Given this, there is a need for caution regarding its usage.

The problem when selecting measurement methods is that there is no benchmark of the “real” size of the informal economy against which the validity of different methods can be judged. As such, the only current option for researchers interested in explaining the cross-national variations in its size is to conduct exploratory analyses using the methods that currently provide data. This paper does so by using the results of the DYMIMIC method. Indeed, the reason

this method is selected is because it is the only method which provides data on a wide range of developed and transition economies, and therefore is the only method that allows exploratory analysis of the competing explanations for cross-national variations in the size of the informal economy in developed and transition economies, namely the EU-28 and five high-income OECD countries (Australia, Canada, Japan, New Zealand and USA). Moreover, given that the correlations between the cross-national variations in the size of the informal economy and cross-national variations in work and welfare arrangements (e.g., tax rates, social protection expenditure) across the EU28 are in the same direction whether the DYMIMIC method, direct survey estimates (Eurofound, 2013; Vanderseyen et al, 2013) or the averages of all indirect survey methods (Williams, 2013a) are used, there is no reason to assume that the results produced using the DYMIMIC method will be any different to the results produced using other measurement methods when examining developed and transition economies.

Here, therefore, the dependent variable is the size of the informal economy, which is defined in the DYMIMIC method as all market-based legal production of goods and services that are deliberately concealed from public authorities for the following reasons: to avoid payment of income, value added or other taxes; to avoid payment of social security contributions; to avoid having to meet certain legal labour market standards, such as minimum wages, maximum working hours, safety standards, etc., and to avoid complying with certain administrative obligations, such as completing statistical questionnaires or other administrative forms (Schneider and Williams, 2013).

To analyze the work and welfare arrangements that each perspective suggests have an influence on the size of the informal economy, indicators are taken from official OECD data sources (OECD, 2013a,b,c,d,e) and World Bank development indicators are used (World Bank, 2013, 2014). The only non-official data sources used are Transparency International's perceptions of public sector corruption index (Transparency International, 2013) and the Inter-Country Risk Guide data on the quality of state bureaucracy (ICRG, 2013). In each case, data for the most recent year available is used and compared with Schneider's estimates for that year.

To evaluate the modernization perspective, four indicators are employed that have previously been used in the scientific literature to evaluate the tenets of this thesis (ILO, 2012; Yamada, 1996), namely:

- GNI per capita based on personal purchasing power standards (PPS) (World Bank, 2014a);
- the employment participation rate (OECD, 2013a), which can be used as a proxy indicator of the level of formalization of economies;
- average wages in 2012 in US dollars in purchasing power standards (OECD, 2013a), which can be used as a measure of development; and



- the ICRG indicator of bureaucracy quality which measures the institutional strength and quality of the bureaucracy and thus the level of modernization of government in nations (ICRG, 2013). High points are given to countries where the bureaucracy has the strength and expertise to govern without drastic changes in policy or interruptions in government services. Countries lacking the cushioning effect of a strong bureaucracy receive low points because a change in government tends to be traumatic.

To evaluate the neo-liberal perspective that the size of the informal economy is a result of high taxes, public sector corruption and state interference in the free market, the indicators previously used in the scientific literature (Eurofound, 2013; Vanderseypen *et al.*, 2013; Williams, 2013a,b) when evaluating these tenets of neo-liberal thought are used, namely:

- Total tax revenue as a percentage of GDP (OECD, 2013b);
- Taxes on personal income as a percentage of GDP (OECD, 2013c);
- Taxes on income and profits as a percentage of GDP (OECD, 2013d);
- Transparency International's Corruption Perceptions Index (CPI), which is a composite index of perceptions of public sector corruption that draws on 14 expert opinion surveys and scores nations on a 0-10 scale, with zero indicating high levels and 10 low levels of perceived public sector corruption (Transparency International, 2013).

Meanwhile, and to analyze both the neo-liberal perspective that state interference leads to larger informal economies, as well as the political economy perspective that larger informal economies are a product of a lack of state intervention in work and welfare arrangements, indicators are analyzed which have been previously used in the scientific literature when evaluating the assumptions of neo-liberal and political economy thought (Eurofound, 2013; Vanderseypen *et al.*, 2013; Williams, 2013a, b), namely:

- level of total social expenditure per head of the population at current prices and taking into account personal purchasing power standards (PPPs) (OECD, 2013e); and
- state expenditure on labour market interventions aimed at correcting disequilibria (Eurostat, 2013). This covers all public interventions in the labour market aimed at reaching its efficient functioning and correcting disequilibria which explicitly target groups with difficulties in the labour market, namely: the unemployed; those employed but at risk of involuntary job loss; and people who are currently inactive in the labour market but would like to work. These labour market policy interventions are broken down into *category 1* interventions (labour market policy services), *category 2-7* interventions (labour market policy measures including: training; job

rotation and job sharing; employment incentives; supported employment and rehabilitation; direct job creation and start-up incentives) and *category 8 and 9* interventions (labour market policy supports covering out-of-work income maintenance and support, and early retirement).

In addition, and given that much work in the informal economy is small-scale fixed-term work conducted on a temporary basis (Vanderseypen *et al.*, 2013; European Commission, 2014), two further indicators are used to evaluate the neo-liberal and political economy tenets that the informal economy results from too much or too little state intervention, namely:

- an OECD indicator on the strictness of employment protection legislation regarding temporary employment (EPT) which measures how easily firms can resort to temporary employment to meet their needs for flexibility and the constraints imposed by regulations on regular open-ended contracts (OECD, 2013a) and
- an OECD indicator on the strictness of employment protection legislation in relation to temporary employment agencies (EPTWA), which measures the ease with which organizations can use temporary work agency (TWA) employment by quantifying the strictness of regulations in a country regarding temporary work agency employment with respect to the types of jobs for which these contracts are allowed and the renewal and cumulative duration of assignments at the user firm, as well as the regulations governing the establishment and operation of temporary work agencies (OECD, 2013a).

Given the exploratory nature of the analysis, it is important to note that if other indicators were to be adopted, such as on minimum standard legislation or the strictness of legislation on collective dismissals, different results regarding the relationship between state intervention and the informal economy might be found. This issue will be returned to in the conclusions to this paper.

To analyze the relationship between the cross-national variations in the size of the informal economy and these various characteristics of work and welfare regimes which the competing perspectives deem influential in determining its size, and given the small sample size of just 33 countries and lack of necessary controls to include in a multivariate regression analysis, only bivariate regression analyses of the relationship between the size of the informal economy and different individual characteristics of the wider regulatory environment are possible. To do this, Spearman's rank correlation coefficient ( $r_s$ ) is used due to the non-parametric nature of the data. Nevertheless, and as will be shown, despite being limited to bivariate regression analysis, some meaningful findings are produced regarding the validity of the different perspectives.

Firstly, the cross-national variations in the size of the informal economy across the 33 countries will be reported and secondly, an exploratory evaluation of the

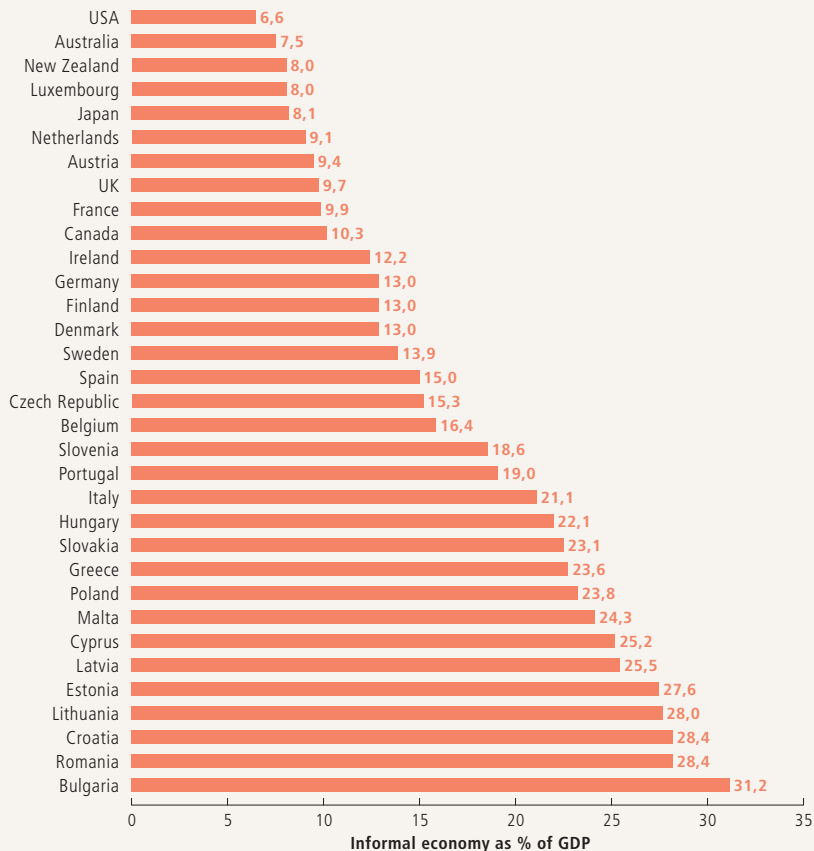
hypotheses will be undertaken by examining whether the broader economic and social conditions deemed important in each perspective are correlated with larger informal economies.

## Results

Across the 28 member states of the European Union (EU-28) and five high-income OECD countries (Australia, Canada, Japan, New Zealand and USA), the unweighted average is that the informal economy is 17.2 per cent of GDP. As Figure 1 displays, however, marked variations exist in the size of the informal economy across these economies ranging from 31.2 per cent in Bulgaria and 28.4 per cent in both Croatia and Romania, to 6.6 per cent in the USA and 7.5 per cent in Austria.

FIGURE 1

### Size of the informal economy as % of GDP



Source: derived from Schneider (2013: Table 1)

others. Generally, most East-Central European and Southern European countries have informal economies larger than the unweighted average for all 33 countries (with the exceptions of the Czech Republic and Spain), whilst all West European, Nordic and other higher-income OECD countries have informal economies smaller than the unweighted average figure for the 33 countries. Thus, how can these cross-national variations in the size of the informal economy be explained?

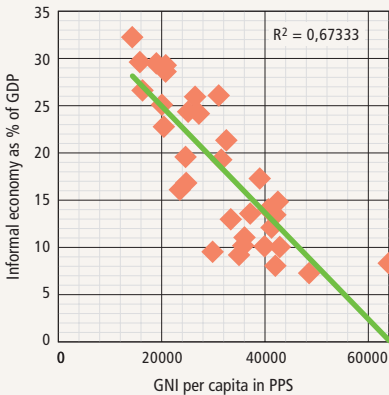
## Evaluating the modernization hypothesis

Figure 2 evaluates the modernization hypothesis (H1) that developed modern economies have smaller informal economies. As Figure 2a reveals, there is a

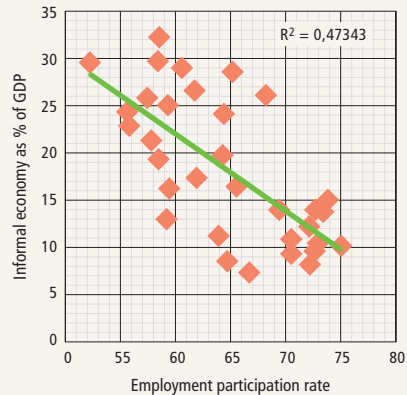
FIGURE 2

### Evaluating the modernization hypothesis

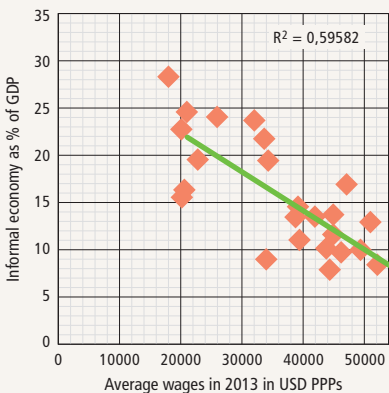
2a Relationship between informal economy and GNI per capita in PPS, 2011



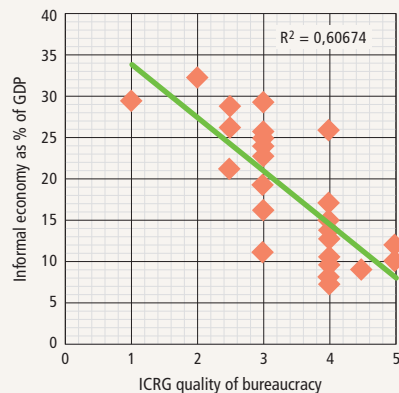
2b Relationship between informal economy and employment participation rate, 2011



2c Relationship between informal economy and average wages, 2011



2d Relationship between informal economy and quality of bureaucracy, 2011



strong significant relationship between the cross-national variations in the size of the informal economy and cross-national variations in the GNI per capita in personal purchasing power standards (PPPs) at the 0.01 level ( $r_s = -.879^{**}$ ). The direction of the relationship is that countries with higher levels of GNI per capita have smaller informal economies. This is similarly the case, as Figure 2b reveals, when analyzing the correlation between the cross-national variations in the size of the informal economy and employment participation rates among the working age population (15-64). There is a strong correlation at the 0.01 level ( $r_s = -.659^{**}$ ) and the direction of the relationship is that higher employment participation rates are correlated with smaller informal economies.

Similarly, there is a strong relationship between average wages (in USD in PPPs) and the size of informal economies ( $r_s = -.771^{**}$ ). Countries with higher average wage rates have smaller informal economies, thus negating any notion that high wage levels result in larger informal economies. Finally, and as a measure of the level of modernization, Figure 2d displays a strong correlation at the 0.01 level between the cross-national variations in the quality of bureaucracy and the cross-national variations in the size of the informal economy ( $r_s = -.669^{**}$ ). The greater is the institutional strength and quality of the bureaucracy and thus the level of modernization of government in nations, the smaller is the informal economy. It is important to state that these associations cannot establish the directionality of the correlation in terms of a cause-effect relationship. This, therefore, is a limitation of the current analysis.

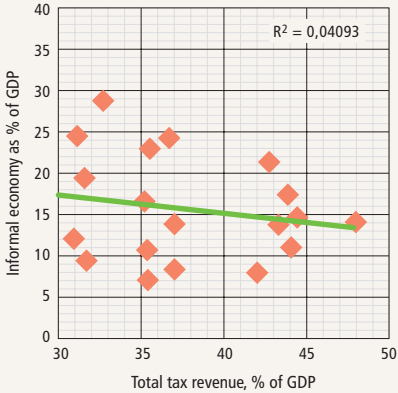
### Evaluating the neo-liberal hypothesis

Figure 3 evaluates the neo-liberal hypothesis (H2) that the size of the informal economy is greater in countries with higher tax rates and greater perceived levels of public sector corruption. Starting with the total tax revenue as a percentage of GDP across the 28 EU member states and five OECD countries, Figure 3a reveals no significant correlation ( $r_s = -0.164$ ). Countries with a larger tax burden are not associated with larger informal economies. Given that this contests a core assumption of the neo-liberal perspective, Figure 3b further examines this using another measure of tax rates, namely taxes on personal income as a percentage of GDP. This again reveals no statistically significant relationship ( $r_s = -.228$ ). As Figure 3c reveals, this is also the case when a third and final measure of tax rates is analyzed, namely, taxes on income and profits as a proportion of GDP ( $r_s = -.422$ ). There is thus no evidence that higher tax rates across these 33 countries are associated with larger informal economies.

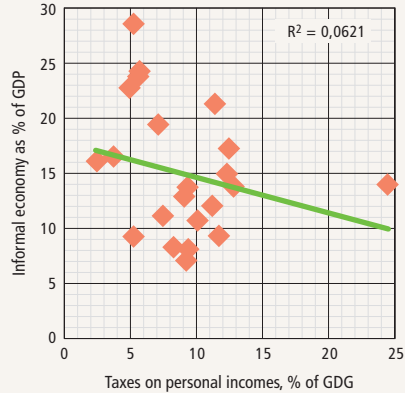
FIGURE 3

## Evaluating the neo-liberal hypothesis

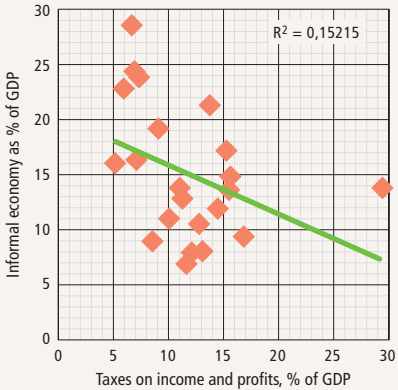
3a Relationship between informal economy and total tax revenue as % of GDP, 2011



3b Relationship between informal economy and taxes on personal income as % of GDP, 2011



3c Relationship between size of informal economy and taxes on income and profits as % of GDP, 2011



3d Relationship between informal economy and and public sector corruption, 2013



This finding reinforces previous research that finds no association between cross-national variations in tax rates and cross-national variations in the size of the informal economy (Eurofound, 2013; Vandeserypen *et al.* 2013). For example, Vanderseypen *et al.* (2013), using the implicit tax rate on labour, the share of labour wages in total taxes and the tax wedge on labour, find no statistically significant correlations.

However, Figure 3d does lend support to the corruption tenet of the neo-liberal thesis, identifying a significant correlation between cross-national variations in the perceptions of public sector corruption and cross-national variations in the size of the informal economy ( $r_s = -.717^{**}$ ). The higher is the perceived level of

public sector corruption, the larger is the size of the informal economy. Thus, is it also the case that higher levels of state interference in the free market lead to larger informal economies, as neo-liberals suggest? Or is it the case, as political economists assert, that the size of the informal economy reduces with greater intervention in work and welfare regimes?

### Evaluating the political economy hypothesis

Figure 4 evaluates these competing theories regarding the relationship between the size of the informal economy and level of state intervention. Starting with the correlation between the cross-national variations in the size of informal economies and the level of total social expenditure per head of the population at current prices and taking into account personal purchasing power standards (PPPs), Figure 4a reveals that the larger the level of social expenditure per head of the population, the smaller is the informal economy and this is statistically significant at the 0.01 level ( $r_s = -0.524^{**}$ ). Examining this aspect of state intervention, support is found for the political economy perspective rather than neo-liberal view. In regulatory environments in which there is greater social expenditure per head, the informal economy is less prevalent since people have an alternative means of support which decreases their need to turn to the informal economy as a survival practice.

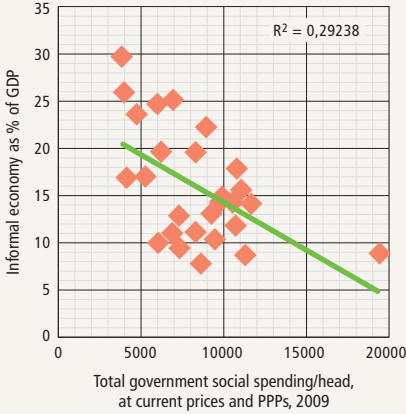
A similar finding is identified when the relationship between cross-national variations in the level of state expenditure on labour market interventions aimed at correcting disequilibria and the size of the informal economy is examined using the proportion of GDP spent by governments on interventions in the labour market aimed at vulnerable groups. As Figure 4b displays, higher levels of expenditure as a proportion of GDP on labour market interventions are correlated with smaller informal economies and this is significant at the 0.01 level ( $r_s = -0.555^{**}$ ), thus again supporting the political economy perspective.

This strong positive correlation is prevalent whichever sub-group of labour market policy interventions targeted at vulnerable groups is considered. There is a strong correlation at the 0.01 level between a reduction in the size of the informal economy and increased expenditure on labour market policy interventions whether category 1 (labour market policy services) interventions are considered ( $r_s = -0.427^{**}$ ), category 2-7 (labour market policy measures) interventions are analyzed ( $r_s = -0.546^{**}$ ) or category 8 and 9 (labour market policy support) interventions are evaluated ( $r_s = -0.696^{**}$ ). Thus, contrary to the neo-liberal thesis, countries with greater expenditure on social protection and higher expenditure on labour market interventions to help vulnerable groups into the labour market have smaller informal economies.

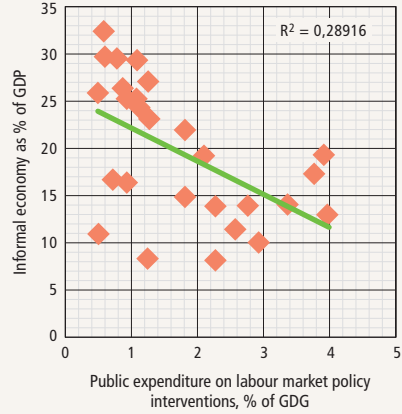
FIGURE 4

## Evaluating the political economy hypothesis

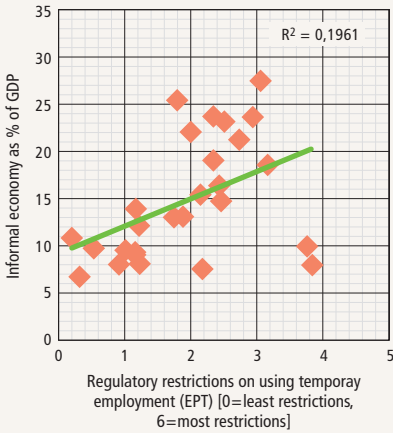
4a Relationship between informal economy and expenditure on social protection, 2009



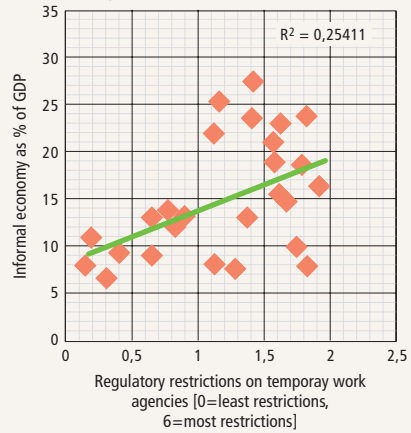
4b Relationship between informal economy and state labour market expenditure, 2010



4c Relationship between informal economy and regulation of temporary employment, 2013



4d Relationship between informal economy and the regulation of temporary work agency employment, 2013



Before concluding that larger informal economies appear to be correlated with too little rather than too much state intervention in work and welfare arrangements, however, it is important to analyze other forms of state intervention beyond social protection expenditure and labour market policy interventions. One important realm of state intervention relates to the regulation of temporary employment. As the 2013 Eurobarometer survey of informal work in the 28 member states of the European Union reveals, the median annual earnings



of those working in the informal economy is €300, with only 12 per cent of participants earning over €1000 (Vanderseypen *et al.*, 2013), suggesting that the majority of participants are involved in small-scale work of a fixed-term nature. Is it the case that the cross-national variations in the regulation of temporary employment and temporary work agency (TWA) employment are associated with cross-national variations in the size of the informal economy?

Marked cross-national variations exist in the strictness of employment protection in relation to temporary employment contracts. Although fixed-term contracts (FTCs) are permitted in some countries, their use must be justified on the basis of an “objective” or “material situation” in terms of whether employees perform a task which itself is of fixed duration, such as seasonal work, or in response to a temporary increase of workload (e.g., Estonia, France, Greece, Luxembourg). In other countries, however, no justification is required to hire a worker on a fixed-term contract, at least for the first contract (e.g., Belgium, Ireland, Italy, Netherlands) but there are restrictions on the number of renewals or successive FTCs under which a worker can be employed by the same firm without interruption. In yet other countries, however, no legal restrictions exist on the number of successive contracts or renewals (e.g., Australia, Denmark, Finland, Japan, New Zealand) (Boston Consulting Group and CIETT, 2013). Figure 3c examines the cross-national variations in the strictness of employment protection in relation to temporary contracts, which measures how easily organizations can resort to temporary employment contracts, and compares this with cross-national variations in the size of the informal economy. The finding is that there is a strong statistically significant correlation at the 0.01 level ( $r_5 = -.492^{**}$ ). The more restrictive are the regulations concerning temporary contracts in a country, the larger is the informal economy, thus supporting the tenet of the neo-liberal view that greater state interference and burdensome regulations result in larger informal economies.

This is further reinforced when examining employment protection in relation to temporary work agencies (EPTWA). Cross-national variations exist in the degree of regulation of temporary work agency employment with respect to the types of jobs for which such contracts are allowed and the renewal and cumulative duration of assignments at the user firm, as well as the regulations governing the establishment and operation of temporary work agencies along with whether workers must receive the same pay and/or working conditions as equivalent workers in the user firm (OECD, 2013a). Figure 4d finds a significant correlation at the 0.05 level between the ease with which firms can turn to temporary work agencies and the size of the informal economy ( $r_5 = .485^*$ ). Again, countries where it is easier to resort to TWAs have smaller informal economies.

In consequence, countries where organizations can easily resort to temporary employment and TWAs have smaller informal economies. Put another way, the

more states make it more difficult for organizations to use temporary employment and TWAs, the larger is the informal economy. One tentative explanation is that this is because in those (mostly European) countries where there is less regulation regarding temporary employment and TWAs, labour market interventions to protect vulnerable groups are stronger. As such, in these countries, temporary work is less precarious than, for example, in North America where strong active labour market policies targeted at helping vulnerable groups are less prevalent and where less restrictive regulation of temporary employment and TWAs will lead to higher levels of precarious work.

## Conclusion

This paper has evaluated critically the competing perspectives which variously explain the cross-national variations in the size of the informal economy to be a result of either under-development (modernization perspective), high taxes, public sector corruption and too much state interference (neo-liberal perspective) or too little intervention in labour markets and social protection (political economy perspective). To conduct an exploratory evaluation of these rival views, their validity when explaining cross-national variations in the size of the informal economy across developed and transition economies, namely 28 European countries and five other OECD nations, has been examined. Reporting evidence on cross-national variations in the size of the informal economy measured using Schneider's (2013) DYMIMIC model, the overarching and necessarily cautious exploratory finding is that the modernization view is validated and although the neo-liberal tenet that high taxes lead to larger informal economies is refuted, the neo-liberal tenet that larger informal economies are associated with greater levels of perceived public sector corruption is supported.

Turning to the neo-liberal view that larger informal economies are associated with too much state interference and the political economy view that it is due to too little state intervention, the finding is that there is a need for a nuanced understanding of this issue. This exploratory analysis reveals that different types of state intervention in work and welfare provision appear to have contrasting impacts on the size of the informal economy. Although the political economy perspective is supported when examining measures of state intervention in work and welfare arrangements such as social expenditure per head and expenditure on labour market policy interventions to protect vulnerable groups, with higher levels of state expenditure being associated with smaller informal economies, this is not the case when examining the regulation of temporary employment and temporary work agencies. Here, the finding is that there are smaller informal economies in countries where there is less regulation of temporary employment contracts and temporary work agencies, and organizations can therefore more

easily resort to temporary employment and TWAs. This has both implications for theorizing cross-national variations in the size of the informal economy as well as policy implications for tackling the informal economy.

Starting with the theoretical implications, commentators have until now adhered to one or other perspective when explaining cross-national variations in the size of the informal economy, exemplified by the recent studies supporting the political economy perspective that greater levels of expenditure on social protection and labour market interventions to protect vulnerable groups reduce the size of the informal economy (Eurofound, 2014; Vanderseypen *et al.*, 2013; Williams, 2013a). Although one recent study calls for the tenets of the modernization view and the corruption tenet of the neo-liberal perspective to be added to the political economy perspective (Williams, 2013b), this nevertheless supports the political economy tenet that smaller informal economies are associated with higher tax rates and greater state intervention in work and welfare arrangements. In this paper, however, the question of whether different forms of taxation and varying types of state intervention in work and welfare provision have different impacts on the size of the informal economy has been investigated. The finding has been that, although all tax rate measures are not correlated with larger or smaller informal economies, different types of intervention in work and welfare provision have different impacts on the size of the informal economy.

The outcome is a tentative call for a more nuanced understanding. Larger informal economies are associated with under-development as measured by lower levels of GNI per capita in PPS, employment participation rates, average wages and the institutional strength and quality of the bureaucracy, higher levels of perceived public sector corruption, lower levels of expenditure on social protection and labour market intervention to protect vulnerable groups, but also restrictions on the use of temporary employment contracts and TWAs. What is now required is the further development of this finer-grained understanding by investigating a wider array of forms and thus indicators of modernization, corruption, taxation and types of intervention in work and welfare provision so as to develop a more complex and nuanced explanation for the cross-national variations in the size of the informal economy. Furthermore, a broader analysis is required of whether these relationships hold, both when a wider range of nations and other global regions are evaluated as well as when time-series data is analyzed for individual countries. These matters could usefully be explored in future research.

This more nuanced explanation for the cross-national variations in the size of informal economies also has clear practical policy implications for reducing informal economies. Over the past two decades, the policy debate on tackling the informal economy has involved evaluating whether targeted repressive

measures and/or targeted incentives are the most effective means for moving work into the formal economy (Dibben and Williams, 2012; Eurofound, 2013; Feld and Larsen, 2012; OECD, 2012; Williams and Lansky, 2013; Williams and Nadin, 2012; Williams *et al.*, 2012). This paper, in stark contrast to this conventional policy literature, strongly intimates that broader economic and social policy measures are important. It displays that tax rates are not associated with the size of informal economies. Instead, smaller informal economies are found to be associated with economic development and the modernization of government, including reducing perceptions of public sector corruption, as well as higher expenditure on social protection and labour market interventions to aid vulnerable groups, but also restrictive regulations on temporary employment and TWAs. Again, whether the same finding emerges regarding the changes required when a wider range of countries and global regions are investigated, as well as whether it remains valid when time-series data is investigated for individual countries, requires further research. If a wider range of nations are analyzed, moreover, then multivariate regression analysis could also be used to correlate how important each characteristic is to the final outcome whilst controlling for other characteristics, including whether restrictive regulations of temporary employment and TWAs remain significantly associated with small informal economies when the interaction effects with more active labour market policies to help vulnerable groups are taken into account. This would overcome a major limitation of the current paper based on a bivariate analysis of just 33 nations.

In sum, this paper has tentatively revealed the strong correlation between cross-national variations in the size of informal economies and the modernization of work and welfare arrangements. If this paper thus stimulates further research across a wider range of nations and also recognition and investigation of the broader policy changes required in work and welfare arrangements to reduce the size of informal economies, then it will have achieved its objective.

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## SUMMARY

### Explaining the Informal Economy: an Exploratory Evaluation of Competing Perspectives

The aim of this paper is to conduct an exploratory analysis of the wider economic and social conditions associated with larger informal economies. To do this, three competing perspectives are evaluated critically which variously assert that cross-national variations in the size of the informal economy are associated with: under-development (modernization perspective); high taxes, corruption and state interference (neo-liberal perspective), or inadequate state intervention to protect workers (political economy perspective). Analyzing the variable size of the informal economy across 33 developed and transition economies, namely 28 European countries and five other OECD nations (Australia, Canada, Japan, New Zealand and the USA), the finding is that larger informal economies are associated with under-development as measured by lower levels of GNI per capita, employment participation rates, average wages and the institutional strength and quality of the bureaucracy, higher levels of perceived public sector corruption, lower levels of expenditure on social protection and labour market intervention to protect vulnerable groups, but also restrictions on the use of temporary employment contracts and TWAs. The outcome is a tentative call to combine a range of tenets from all three perspectives in a new more nuanced and finer-grained understanding of how the cross-national variations in the size of the informal economy are associated with broader economic and social conditions. The paper concludes by discussing the implications for theory and policy, including the need for further analysis of the different impacts on the size of the informal economy of a wider range of indicators of modernization, corruption, taxation and types of state intervention.

KEYWORDS: informal sector, undeclared work, employment relations, economic development, developed countries.

## RÉSUMÉ

### Expliquer l'économie informelle : évaluation exploratoire de perspectives concurrentielles

Le but de cet article est de procéder à une analyse exploratoire des conjonctures économiques et sociales générales associées aux grandes économies informelles. À cette fin, trois perspectives concurrentielles font l'objet d'une évaluation



critique qui confirme, à maints égards, que les variations observées d'un pays à l'autre quant à la taille de l'économie informelle sont associées aux facteurs suivants : 1- le sous-développement (perspective de modernisation); 2- une taxation élevée, corruption et ingérence de l'État (perspective néolibérale); ou 3- une intervention étatique inadéquate pour protéger les travailleurs (perspective d'économie politique). En analysant la taille variable de l'économie informelle dans 33 économies développées et en transition, soit 28 pays européens et cinq autres pays membres de l'OCDE (Australie, Canada, Japon, Nouvelle-Zélande et États-Unis), l'auteur arrive à la conclusion que les grandes économies informelles sont associées au sous-développement, lequel est mesuré en fonction de plusieurs facteurs : niveaux inférieurs de RNB par habitant; taux de participation à l'emploi; salaires moyens; force et qualité institutionnelle de la bureaucratie; taux élevés de corruption perçue au sein de la fonction publique; faibles niveaux de dépenses au chapitre de la protection sociale; et intervention du marché du travail pour protéger les groupes vulnérables, mais, également, recours restreint à des contrats de travail temporaires et des affectations temporaires. Au final, cette analyse est un encouragement à combiner les facteurs associés à ces trois perspectives pour en arriver à une compréhension plus nuancée et plus fine de la mesure dans laquelle les variations transnationales de la taille de l'économie informelle sont associées à des conjonctures socioéconomiques plus générales. En conclusion, l'auteur s'interroge sur les implications de cet exercice sur la théorie et la politique, et il souligne la nécessité de pousser plus loin l'analyse des différents impacts qu'aurait, sur la taille de l'économie informelle, une gamme plus large d'indicateurs de modernisation, de corruption, de taxation et de types d'intervention étatique.

**MOTS-CLÉS :** secteur informel, travail au noir, relations d'emploi, développement économique, pays développés.

## RESUMEN

### Explicar la economía informal: una evaluación exploratoria de las perspectivas concurrentes

El objetivo de este artículo es de conducir un análisis exploratorio de las condiciones económicas y sociales más amplias asociadas a las economías informales. Para esto, se evalúan críticamente tres perspectivas concurrentes que de manera diversa afirman que las variaciones entre naciones en cuanto al tamaño de la economía informal son asociadas: al sub-desarrollo (perspectiva de modernización); a niveles altos de imposición, corrupción e interferencia estatal (perspectiva neo-liberal), o a una intervención estatal inadecuada de protección de los trabajadores (perspectiva de la economía política). Al analizar el tamaño variable de la economía informal en 33 economías desarrolladas y en transición, precisamente 28 países europeos y 5 otras naciones de la OECD (Australia, Canadá, Japón, Nueva Zelanda y Estados Unidos), los resultados muestran que las más grandes economías informales son asociadas al sub-desarrollo medido por los niveles bajos de GNI per capita, tasa

de empleo, salarios promedio y fuerza y calidad de la burocracia, altos niveles de percepción de corrupción del sector público, bajos niveles gastos en protección social y de intervención en el mercado laboral para proteger los grupos vulnerables, pero también restricciones en uso de contratos de empleo temporario y TWAs. El resultado es una propuesta tentativa de combinar una serie de principios de las tres perspectivas para proponer una nueva comprensión más sutil y refinada de las variaciones de tamaño de la economía informal entre las naciones, haciendo resaltar la asociación con las condiciones económicas y sociales más amplias. El artículo concluye con una discusión sobre las implicaciones para la teoría y las políticas, incluyendo la necesidad de análisis más profundos de los diferentes impactos de una vasta serie de indicadores de modernización, corrupción, imposición y tipos de intervención estatal sobre el tamaño de la economía informal.

**PALABRAS CLAVES:** sector informal, trabajo no declarado, relaciones de empleo, desarrollo económico, países desarrollados.