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## ADVANTAGES AND DISADVANTAGES OF THE INFORMAL SECTOR ENTREPRENEURSHIP VS EMPLOYMENT

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### Abstract

The informal sector is an important part of economy. The influence of the informal on the evolution of the economy can be positive, negative or a mixed between them.

Most of the time, the option for informality of individuals is based on a cost-benefit analysis of the informal sector, but there are also situations when choosing the informal sector is the only option that some individuals have for survival.

In this paper we want to show, starting from different existing studies in the field of informality, what are the advantages and disadvantages for which individuals opt for the informal sector of the economy, both as employees on the labor market and as entrepreneurs and if would be benefical for the economy reduction or expansion of this sector of the economy.

### Keywords

informal sector, informal employment, dual economy, employment in the informal sector.

### JEL Classification

E26, J46, J48, J24.

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### Introduction

The term "*informality*" came into economic theory in the 1970s, when Keith Hart first used this concept in a paper discussing urban occupation in Ghana. From then until today, the concept of "*informality*" has evolved from "simple trading activities carried out by the poor population from developing economies" and to the concept of "*informal employment*", approached through the jobs or workers perspective and that of "*employment in the informal sector*", approached through the employer perspective.

The duality labor market, formal and informal, is a characteristic of any labor market, whether we refer to a developed or a developing economy, the difference between them being given by the reason that determines individuals to opt for informality in the sense that, in the developed economies the option for informality is given by the desire to make more profit,

and in the developing economies, informality is, most of the times, a safety valve, being the safe alternative for certain individuals ensure existence.

Informality appears in the relationship between "state", as a regulator, and the other participants in the economic life, respectively "entrepreneurs" and "individuals", when they act as traders (entrepreneurs) and suppliers of labor force (individuals) and not conforms to the legal norms, established by the "state".

Except the situation when informality is the only alternative, the option for informality is based on a cost-benefit analysis, more precisely an analysis of the advantages and disadvantages of the informal sector of the economy. Thus, both the entrepreneurs and the labor force providers make a cost-benefit analysis, taking into account the financial benefits they obtain by opting for informality, but also the risks they are facing leaving the formal sector of the economy. The most important risks to the participants in the economic life leaving the informal sector of the economy are: the risk of penal liability before the law (in the case of companies or entrepreneurs) as the informality is, in fact, tax evasion, and this is considered penal liability in the law of majority countries of the world and the risk of not benefiting from the social protection system offered by the state to formal workers, in the case of individuals who choose to work informally.

Although most economists have seen "informality" in quantitative terms, considering it to be a sector where productivity is low, earnings from work are small, commercial activities are conducted without benefiting from the advantage of modern technology existing in the formal sector, there are also authors (Hart, 2011) who interpreted "informality" from the perspective of absence or presence of the "bureaucratic" form.

### **Structure of the informal sector of the economy**

It is essential that before we discuss the basic issue of this paper, namely the advantages and disadvantages of the informal sector of the economy, we should make a brief presentation of the informal sector, both from point of view of employees (jobs perspective) and point of view of entrepreneurs (production units perspective).

In a general sense, the prifile literature uses various concepts to define informality, such as: underground economy, dual economy, tax evasion, and from the labor market perspective "informality" is found in economic theory under several names, among which we mention: Informal sector (Hart, 1973); Undeclared work (European Commission, 1998); The informal economy (BIM, 2002); Employment in the informal sector and informal employment (BIM, 1993/2003); Invisible or hidden occupation (OECD, 2004).

The concepts of "*employment in the informal sector*" and "*informal employment*" have been proposed by the International Labor Office (ILO) to define informal work both from the entrepreneur perspective (employer/enterprise) and from the employee perspective. Thus, the term "*employment in the informal sector*" appears in 1993 and defines the informal work in terms of production units characterization (approaching from the production/enterprise perspective), and the term of "*informal employment*" appears in 2003, defining informal work through the individual perspective, that is, the workforce providers (approach from the workplace or employee perspective). (ILO, 1999; 2012)

According to the resolution adopted by ILO at the 15th International Conference of Labor Statisticians, it is recommended to classify informal activities into two categories, namely: on the one hand the informal activities of the entrepreneurs, and on the other hand the activities of informal workers (individuals providing labor force), thus developing the concept of "informality" (Solorzanoand and del Miguel, 2003).

Once we have clarified from a terminological point of view the concepts of "informal employment" and "employment in the informal sector", the conceptual aspect of the informal sector remains to be clarified. The informal sector of the economy can be terminologically associated with the concepts of underground economy, dual economy or tax evasion.

According to the literature, "*Underground Economy*" can be defined as "representing all those economic activities that are taken into account when establishing the gross national product but which are not registered" (Feige, 1989, Schneider, 1994; Frey and Werner, 1984; Herald and Lubell, 1991) or "representing the production of goods and services of the market, whether it is produced legally or illegally and which is not taken into account in the official estimates of gross domestic product" (Smith, 1994).

Concerning to the informal sector of economy, seen as "evasion", the context in which evasion occurs must first be specified. In any economy, irrespective of its degree of development, there are three categories of participants in the economic life, namely: the *state* - which appears in its double quality, respectively market regulator and consumer or service provider; *companies or entrepreneurs* - as economic agents focused on profit and *individuals* - who appear as labor force suppliers but also as consumers of goods and services. There are interdependence relationships between the three categories of participants in the economic life (Marinescu, 2018).

In the specialty literature, there are considered to be three types of relationships between entrepreneurs (firms), individuals (labor force providers) and the state (regulator), namely: opportunistic evasion, defensive evasion and passive evasion, defined as follows (Perry and Maloney, 2007).

"Opportunistic evasion" refers to the law elusion subtracting from the payment of taxes or fees and can be: illegal (when entrepreneurs engage in non-punishable activities) and unprotected (when workers, especially from developing countries, do not are protected by labor law). Firms that practice this type of evasion, bypassing labor law, implicitly create a dual labor market.

"Defensive evasion", which refers to elusion of taxes and fees due to the overly burdensome tax system, which basically forces taxpayers to enter into a defensive evasion. Also, the high registration costs corroborate with the bushy legislation existing in many states, especially in the developing ones, makes that entrepreneurs give up to formal activities and prefer the information sector.

"Passive evasion" refers to the kind of informality that entrepreneurs choose it because they do not consider that they are part of the formal economy, because they do not need the state services for their activities, which is why they prefer to remain in the informal sector of economy, and employees (labor force providers) consider it a temporary "safety net", sometimes even more important than access to social services specific to the formal sector of the economy.

According to the specific literature (Perry and Maloney, 2007; Ruffer and Khinght, 2007), the informal sector of economy is structured as follows: *the workforce*, which includes workers, especially the elderly, young people and women, who would prefer a job in the formal sector, but they are unable to find one; *entrepreneurs*, ie individuals who have voluntarily left their jobs in the formal system to start a business on their own, where they are their own bosses and where they can earn higher incomes and, at the same time, avoid paying taxes and fees; *small companies* that, on the one hand, do not have the intention or the potential for growth and, therefore, do not want and not need to interact with state institutions, and the other hand they would like to develop, but are hit by regulations and excessive costs, imposed by the formal system; *companies in the formal field*, which, although registered legally, partially carry out informal activities, in the sense that: declare lower incomes to pay lower taxes or do not draw up employment contracts for all employees, or declare amounts lower than they offer them in reality, thus avoiding the payment of social insurance due (Marinescu and Valimareanu, 2019).

The structure of the labor force operating in the informal sector of the economy consists of two categories, namely: entrepreneurs (or self-employed) comprising: small family firms, liberal professions (accountants, doctors, lawyers, etc.), as well as those individuals with some

professional skills and who carry out activities on their own (artisan workers, tailors, hairdressers, etc.) and employees that include: workers in domestic work, unskilled workers in small businesses, workers in large firms that work without legal forms, contract workers who do not receive a regular wage, but are paid in percentage, on commission (Perry and Maloney, 2007).

### **Advantages and disadvantages of the informal sector**

There are two opinions about informality, almost antagonistic, that have been shaped over time. One (older) who argues that the informal sector is characterized by poverty and that it represents a source of non-productive workforce and a second (newer) opinion, which states that this sector may have potential for accumulation and development.

Starting from the two points of view, a summary of the different studies on this topic will show us the advantages and disadvantages of the informal sector, and whether a reduction or expansion of this sector would be beneficial for the economy.

In the literature, the advantages and disadvantages of the informal sector are approached from three points of view: economic, social and political (Tanzi, 1982; Harding and Jenkins, 1989; Portes et al., 1989; Feige, 1989; Renooy, 1990; Gerxhani, 2004; Chen, 2016; Fields, 2008; Reynaud, 2002).

In this paper we will address the three criteria, by which the advantages and disadvantages of the informal sector are defined, both from the point of view of the entrepreneur (the employer) and from the perspective of the employee (of the labor force provider).

- *The economic criterion*

The economic advantages and disadvantages of employment in the informal sector of economy are different, depending how individuals relate to economic life, as entrepreneurs (employers) or as workers (employees).

From the entrepreneur (employer) point of view, the main economic advantage is given by the greater profit obtained from the informal activities, by no taxes payment and this is achieved by no income declaring, but also paying "to the black" workers, employed without legal forms. These advantages allow informal sector entrepreneurs to have lower production or operating costs than those in the formal sector, and these savings on the one hand can be used in development investments and on the other hand they can allow them to practice lower prices on the market, thus unfair competition to companies in the formal sector of the economy.

The main economic disadvantages of the entrepreneurs, translated by risks and costs, are the following (Perry and Maloney, 2007): the risk that the evasionist entrepreneur will be caught by the state control bodies and, apart from penal liability, the evasionist may be charged with payment of the amounts due to the state, to which interest and penalties may be added; the impossibility to conclude legal contracts with other companies; do not have access to bank loans and other financing lines; they cannot benefit from the programs, incentives or grants offered by the government; they cannot expand their retail market or customer area.

Regarding informal work, the main benefit of informal workers is they do not pay taxes on wages and on social and health insurance, and in this way they have more money for their living needs. As a disadvantage, informal workers do not benefit from the social protection offered by the state to employees with legal forms, which means that informal workers will have to pay for their medical services alone, in case of sickness, services that can be extremely expensive, especially in developed economies. Another economic disadvantage of informal work is the lack access of informal workers to loans.

Not only entrepreneurs and workers benefit from the informal sector of economy, but even the state. The economic advantage that the state can have, by existence of the informal sector, of course, given that its size is within acceptable limits by the state, consisted in the fact that the poors, for which the state should provide social aid and unemployment benefits, could

benefit from (informal) income, thus relieving the state of the payment of those social benefits. However, as far as the state is concerned, the economic disadvantages of informality are far greater than the benefits of the informal sector, because the informal sector of the economy causes distortions of some economic indicators, such as unemployment rate, inflation rate, etc; causes financial losses to the state budget, generating budget deficits (tax evasion); results in a further increase in tax rates; makes unfair competition to companies from the formal sector; it is often characterized by low productivity and low incomes.

- *The social criterion*

Informality can be viewed as the result of voluntary "exclusion" or "exit" from the labor market, depending on the factors that cause workers to leave the formal sector of the labor market (Perry and Maloney, 2007).

Thus, informality appears as a result of "exclusion" from the market when the formal sector does not provide enough employment opportunities, bureaucracy is excessive and blocks access to formality or when the costs of becoming "formal" are high. Also, informality can also be interpreted as a result of the "exit" from the market when formal employment does not bring sufficient benefits to the workers or when they do not trust in public institutions. In this case, potential "formal" workers prefer to become entrepreneurs in the informal sector of the economy or informal workers.

When informality is the result of the "exit" from the formal labor market, there are a number of social advantages that, together with economic benefits, motivate individuals to opt for the informal sector.

The main social advantage for both entrepreneurs and informal workers is the flexibility of work in the informal sector.

As the formal labor market is known, although it has many advantages, it has the disadvantage of being extremely rigid, and this is due to the excessive regulations imposed by the state. Precisely this lack of flexibility was considered the main (but not the only) cause of the informal economy expansion. In most states, there are three categories of regulations that affect the level of flexibility of the labor market, namely: the law on labor contracts, the law on collective bargaining and the law on entrepreneurship, meaning the regulations that allow starting a business (Marinescu and Valimăreanu, 2018).

Work flexibility refers to: labor mobility (measured by the opportunity cost of urban incomes, urban unemployment and urban rents related to informal earnings), training and qualification of workers (most workers in the informal sector carry out unqualified activities and are willing to accept wages small) and to social exclusion on ethnic or other criteria (persons with disabilities, women) and it is specific to the informal sector and it is the opposite of job security, which characterizes the formal labor market (Marinescu and Valimăreanu, 2018).

In any job market, there is an increasingly fierce battle between employers, who want more flexibility and employees, who want more security. Thus, the concept of "*flexicurity*" is born (Crețu, 2010), which refers to that balance between labor market flexibility and job security, accepted by both parties, employers and workers, and which can be obtained when the contributions of work adapts relatively easily to the demand of the workforce, while ensuring a reasonable level of protection for workers (De Gobbi and Nesporova, 2005).

Therefore, the social benefits offered by the informality of the work refer mainly to the fact that the informal sector offers more flexibility to both employees and entrepreneurs, which allows individuals to have more time for household activities, entertainment, leisure or human capital development, and secondly that informal jobs are preferred by individuals rather than no income.

The social disadvantages of the informality of work refer to the fact that the informal sector implies worse working conditions than the formal sector, excludes workers from social security and offers both workers and entrepreneurs an unfair advantage, because they do not pay taxes or social contributions, compared to those in the formal sector.

- *The political criterion*

Political advantages of work informality refer to the fact that the informal system can be a "safety valve" for unhappy individuals and for social tensions in the economy, especially when social aid is small or even non-existent, and informal workplaces are often tolerated by governments or even encouraged, especially in developing countries, to obtain political capital.

The political disadvantages of the informality of the work are related mainly to the official statistics of the informal sector. Because informal activities, most of the time, are not included in the GDP measurement, statistics will give decision makers an unrealistic view of the economic reality.

### **Conclusion**

Informality involves taking risks, whether we refer to "informal employment" or "employment in the informal sector" of the employees, or we are talking about tax evasion, in the case of the entrepreneurs. If in the case of employees, the main risk is the lack of job security and instability, in the case of entrepreneurs who carry out informal activities, which involve tax evasion, the main risk is to be caught by the state control bodies and therefore sanctioned contraventional or penal.

Speaking about taking risks, Taleb says he does not refuse idea of risk taking, but "criticizes encouraging uninformed risk taking." Taleb insists that if "we arrived here by accident, it does not mean that we should continue to take the same risks. We are a mature enough breed to realize this; we must enjoy the blessing and try to keep what we have acquired through luck, becoming more conservative. I played Russian roulette; now, however, it is time to stop and find a serious job to do" (Taleb, 2009). Thus, both workers and entrepreneurs who opt for informality should be well informed about the risks they are taking when choosing informal activities. Unlike workers who opt for informality because of the lack of an alternative, entrepreneurs choose informality, through a cost-benefit analysis, which is why they need to know very well the risks of informality and know when to abandon the "Russian roulette" that Taleb talks about it and they legalize their business become formal.

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