BEYOND FORM AND RULE. MAKING MORE OUT OF INFORMALITY

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Abstract. *A shifting perception of informality is an attribute of the development project, which entails a specific approach to development; one that has been dominant since the end of the Second World War. We argue that this has facilitated the persistent enlargement of the informal economy, thus presenting a case for the re-visitation of notions of dualistic development, which challenge the assumption that developing countries can modernize by following the same path used earlier by their developed counterparts. This view has been endorsed by an emphasis on the role of backward and forward linkages between the formal and informal economies. Our view is that this approach is theoretically flawed and thus not a compelling alternative to dualism. Its dominance is related to the tendency of the development project to ease commercialization rather than formalization, resulting in the expansion of informality. To reflect this in a policy context, we use the case of microfinance, which we see as a component of the development project. To illustrate this in more detail, we refer to examples from India and Pakistan*

Keywords: *informal economy; informality; dualism; development; microfinance; high development theory; linkages.*

Introduction

We argue that the persistent expansion of informality should be ascribed to a specific approach to development that has been ascendant since the end of the Second World War. Some of the terms associated with this agenda are neoliberal, mainstream, globalization, and Washington Consensus. We prefer the term 'the development project' and apply this to review the origins and shortcomings of the fixation with the issues of why and how to formalize the informal. Shifting perspectives on informality are connected to the evolution of development thought. A closer understanding of this relationship can cast important insights on present day policy interventions such as microfinance and the issues related to its governance.

The development project is described as an initiative that emerged in the United States following the Second World War and "enlisted social scientists to study and devise ways of promoting capitalist economic development and political stability in newly independent, and 'developing' states throughout the world" (Halperin, 2007). Modernization theory was an outcome of this endeavor, which sought to establish capitalist structures for the purpose of economic development. The underlying assumption was, and continues to be, that developing countries can modernize by following the same path used earlier by their developed counterparts.

A shifting perception of informality is an attribute of the development project. Policymakers have struggled to form appropriate responses to informality which is seen, in its current shape, as an impediment to growth and development. Recent approaches to economic development may be contrasted with earlier ones in which the informal economy and formal economy were the components

of a dual economy which had a non-participating informal segment and a participating formal segment. Eventually, the expansion of the latter would result in the absorption of the former.
The development project has entailed a departure from this view and focused on the linkages between the formal and informal economies. This understanding of informality has overseen the commercialization rather than the formalization of the informal economy. This process is problematic not only because it has resulted in an expanding informal economy, but because informality is linked to poverty (OECD, 2009).

The notion of linkages may also be related to the microfinance based development paradigm which has been shown to promote informality. It may be shown that the nature of the backward and forward linkages formed through microfinance do not allow for the creation and enlargement of efficient and productive firms. However, institutional support for microfinance institutions ensures that informality will continue to expand. This reflects the tendency of the development project to promote commercialization over formalization. This, we argue, is a basis to revisit the notion of dualistic development.

Our purpose is to follow the development of the concept of informality over time, thus examining how changes in conceptualization reflect the influence and goals of the development project. Our approach entails two stages and the remainder of this paper is structured accordingly. The first of these stages is the focus of the next section which critically examines the relationship between shifting perceptions of informality and the development project. The second stage is the focus of the subsequent section on those experiences of the microfinance sector that have yielded insights about the validity of these perceptions. The discussion is then summarized in the final section which presents conclusions.

Shifting perceptions of informality and the development project

A shifting perception of informality may also be attributed to the development project, and it may thus be argued that the growth of the informal economy is an outcome of variation in conceptualization. Clement (2015) takes the view that an unrelenting belief in the trickle-effects of liberal growth policies has resulted in economic exclusion as marginalized groups find themselves barred from the formal economic segment. Her view is that the theoretical nexus between informality and marginalization may be found through a historical assessment of economic thought since the 1940s. She identifies three distinct phases of informal economy conceptualization. The first of these is the 1940s and 1950s when the discourse was shaped by the thought of Julius Boeke (as cited in Clement, 2015), Arthur Lewis (1954), and Albert Hirschman (1981). The second of these is the 1960s and 1970s when new definitions were developed by Keith Hart (1987) and the ILO (1972). The third phase marks a period of renewed interest, mostly over the last two decades, with prominent contributions from Hernando de Soto (2000), Friedrich Schneider, and Dominik Enste (Schneider & Enste, 2013).

The earliest of these phases may be seen in the context of high development theory, dominant in the 1940's and 1950's, where the prevailing view of growth was "that development is a virtuous circle driven by external economies -- that is, that modernization breeds modernization" (Krugman, 1994). Lewis is of course one of the foremost high development theorists and his dual sector model which assumed that low-income traditional economies could be transformed into dynamic modern economies, is consistent with the development literature of this era.

Clement (2015), and Gerxhani (2003) remind us that the Dutch economist, Julius Boeke, discussed the informal/formal dichotomy as early as 1953. This should not come across as surprising since the notion that developing countries must undergo the same stages of growth experienced in the past by developed countries was not taken for granted at that time. In this same vein, Hirschman's early work emphasized how dualism was preferable to theories that advocated a 'Big Push'[1] for the sake of a Rostowian 'take off' (Rostow, 1960). Later work by Hirschman (1981) emphasized the importance of backward and

[1] This term was coined by Rosenstein-Rodan in 1943 who theorized that developing countries require massive investments in order to attain a sustained growth path (Krugman, 1994).

forward linkages. This concept was, after the 1970's, revisited in studies of the informal economy and used to prepare policy approaches that rejected dualism. These will be discussed later in this paper.
The second phase of conceptualization began in the 1970's with Keith Hart's African study providing a definitive break by noting that "the informal economy might be a passive adjunct of growth originating elsewhere or its dynamism might be a crucial ingredient of economic transformation in some cases" (Hart, 1987).

The term 'informal sector' which came to replace a number of others, such as, subsistence, traditional, preindustrial or unorganized sector, is attributed to Hart (Clement, 2015)[2]. Hart's work roughly coincided with the publication of an International Labour Organization report published in 1972. Both studies took a positive view on informality and concluded that the sector had considerable potential for income generation (Chen, 2012). In addition, the consensus on a specific term facilitated the construction of operational definitions, leading to empirical studies based on quantitative approaches. Chen (2012) notes that the "informal sector as an economic reality received a mixed review in development circles" with no agreement on whether it would eventually disappear or whether its expansion should be anticipated under the assumption that industrial development would not follow the pattern seen previously in developed countries.

The subsequent phase of conceptualization reflects the changes that were attributed to globalization as the "production of goods and services was being subcontracted to small-scale informal units and industrial outworkers" (Portes, Castells & Benton, 1989 as cited in Chen, 2012). As a result, developed countries found their way into the informality debate, which had previously taken place only in a development studies context. Within the ensuing literature, it is possible to make a distinction between what Gerxhani (2003) calls optimistic and pessimistic approaches. The debate on optimistic and pessimistic approaches is centered around the questions of why and how to formalize the informal, and includes developed as well as developing countries.

The former, or pessimistic view may be seen in (Levy, 2008, and Farrell, 2004, as cited in in La Porta and Shleifer, 2014) where informal firms are described as parasitical, freeloading, and detrimental for the formal economy. The latter, optimistic view is reflected in the work of De Soto (2000) where informal firms hold potential immense enough to unleash developmental forces, once they are formalized[3]. What both views have in common is that they contend that the informal economy should be formalized through regulation, whether to facilitate formal players or to set free the dynamic potential of informal players.

The above may be contrasted with dualistic approaches to development that see the economy, and often also society, as divided into two segments. The dual view, particularly in the Lewis model, assumes the eventual integration of both sectors. This is associated with the resolution of structural issues resolved through economic forces; particularly those related to the interplay between rising wages and marginal productivity. Among the reasons behind the resurgence of interest in the dual economy perspective is the Chinese growth story. Cai (2015) attributes China's shift to low birth and mortality rates and high growth rates, from high birth and mortality rates, and low growth rates, as an outcome of dualistic development as surplus labour was absorbed by urban areas from rural areas. Now that the transition appears to have been completed, neoclassical conditions appear to hold as labour shortages and wage increases are experienced. These occurrences indicate that a Lewisian turning point has been reached.

Two observations may be made regarding the difference between dualistic approaches and alternatives. One, that dualistic views are centered on developing countries, and two, that dualistic approaches hold that development flows from the formal to the informal. Clement (2015) contends that this standpoint, in which a subsistence economy coexists with a modern economy has more validity than the notion of a continuum where a "distinct informal sub-economy is encapsulated within the formally accounted

[2] Hart's work drew attention prior to its official publication in 1973 and is credited with introducing the term into the academic literature (Swaminathan, 1991, Gerxhani, 2003, Clement, 2015). Clement (2015) also notes that the widespread acceptability of the term may also be attributed to the International Labour Organization report published in 1972 which used Hart's term.
[3] De Soto takes the view that the process of formalization should be facilitated by authorities through the easing of regulation.

economy". The dualistic approach has also been endorsed by La Porta and Shleifer (2014) who find that empirical evidence supports the dual view of informality. They observe that the informal economy is extremely large, and characterized by low productivity, which keeps it persistently separate from the formal economy, with informal firms rarely transitioning into formal firms. Informality shrinks only when the overall economy grows and develops. These characteristics are consistent with the dual view of development.

Among the conclusions that La Porta and Shleifer (2014) draw from their analysis is that informal economies are large in poor countries because their entrepreneurs are overwhelmingly unproductive. So, the only way to shrink the informal economy is by growing the formal economy; this may be done by increasing the supply of educated entrepreneurs. This may be done either through immigration or education and training.

This perspective recommends policy intervention, hence advocating a role for the state, particularly beyond taxation and regulation. Such an endorsement is inconsistent with the practices of the development project, which has come to rest on a neoliberal ideology. A role for the state is a natural corollary of the assumption that there are bottlenecks that prevent labour from moving away from the low wage informal economy to the high wage formal economy. Ranis (2004) notes that even though Arthur Lewis did not subscribe to the notion that an all powerful state was a precondition for development, he did emphasize the need for government planning, complemented by the private sector

Given this, it is not surprising that the development project describes the informal economy quite differently. A recent instance is the WIEGO sponsored paper by Kate Meagher (2013) in which the dual economy perspective is discredited based on "the extent and nature of linkages between the formal and informal economies". The study, an extensive literature review on the informal economy in developing countries, takes the view that definitional debates no longer dominate the literature given that the focus of research over the last two decades has been on how to utilize the "prevailing conceptual definition"[4] to formulate policy. The focus of Meagher's study is linkages. This is pertinent in our own context because the models in which linkages are presented as an alternative to dualistic development become questionable, when studied in the context of high development theory[5].

Much of the literature developed during the 1990's and after has been influenced heavily by the concept of mapping linkages. This approach to analyzing relationships between economic players is based on the work of Hirschman (1981) who distinguished between forward and backward linkages. The former occur when a firm's output is used as an input in further production, whereas the latter occur when the firm purchases intermediate inputs. Even, before Hirschman coined the terminology, the role of forward and backward linkages was discussed in the literature and it was noted that the production of intermediate goods could have positive feedback effects. Fleming (1955 cited in Krugman, 1994), whose work was contemporaneous with Lewis', emphasized the role of intermediate goods in production. As such, a developmental path may be attained even without dualism.

The linkages approach may be regarded as opposing dualism, "without calling into question the underlying distinction between the formal and informal spheres" (Meagher, 2013). So rather than seeing the overall economy as one where development flows from the formal to the informal, the economy is one comprised of multiple linkages between the formal and informal sectors. In this economy, the formal sector uses inputs produced in the informal sector, and vice versa. A key assumption here is that informal businesses hold value from a growth perspective and that there are advantages to commercialization even when that does not translate to formalization. Since here, the informal economy has a role to play in supporting the formal economy, there is no overwhelming basis for a policy intervention that seeks to expand the formal economy in order to contract the informal one.

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[4] The definition referred to is "income generating activities operating outside the regulatory framework of the state" (Castells & Portes, 1989; De Soto, 1989; Feige, 1990; Harding & Jenkins, 1989, as cited in Meagher, 2013).
[5] High development theory is based on "the view that development is a virtuous circle driven by external economies -- that is, that modernization breeds modernization" (Krugman, 1994).

The optimism versus pessimism debate about the growth effects of the informal economy may also be seen within a linkages framework. Optimism is based on the assumption that forward linkages will prevail and allow for accumulation and development in the informal economy. Pessimism arises from the view that backward linkages will continue to dominate because the informal economy is constrained by low skills and productivity.

The literature appears to support the pessimists and points to the dominance of backward linkages over forward linkages (Meagher, 2013). Ranis and Stewart (1999) observe that based on evidence from African countries, informal firms tend to purchase inputs at retail prices from formal sector firms but are constrained in terms of selling their output. This is so because their inability to modernize restricts their product to tiny low-income markets with poor informal producers and consumers. Additionally, the studies from 2000 onwards show that "market reforms have failed to improve forward linkages with the formal sector", highlighting the need for "technical, financial and infrastructural support particularly for the modernizing segment of the informal sector" (Meagher, 2013).

Perhaps the most compelling critique of the linkages approach may be found in Krugman's (1994) paper on the relevance of development economics. Here, he emphasizes the importance of the concept of 'economies of scale' to development theories; "Consider, for example, what may have been Hirschman's most cited concept, that of "linkages." Some crude followers of Hirschman have identified these directly with having a lot of entries in the input-output table. But Hirschman's own discussion makes it clear that the idea involved the interaction between market size and economies of scale" (Krugman, 1994).

Hirschman's emphasis was on the role of profitability thresholds. In his model these may be attained through linkages when economies of scale are reached. So, backward linkages will facilitate the establishment of an upstream industry and push other industries over the threshold. Similarly, forward linkages will reduce costs for potential downstream product users.

The African example mentioned above indicates that the potential of profitability from scale exists only for the formal economy. This is through backward linkages as the informal economy consumes what the formal economy produce. The converse is unlikely because low skills and productivity bar the informal economy from selling to the formal economy. So, capital accumulation occurs only in the formal economy. This is consistent with dualism. Thus, even though the linkages approach and the heterogeneity it reflects may come across descriptively accurate, a more detailed analysis indicates that dual approaches still hold relevance from the standpoint of development.

Also worth noting is that linkages allow for an analysis of informality that does not see the issue exclusively as a developing country phenomenon. This has suited the development project which has intellectual roots in the modernization theory of Rostow (1990, as cited in Halperin 2007). The proponents of this theory have "constructed a highly idealised account of the path that had been traversed by today's advanced countries, and then claimed that developing countries could follow it." (Halperin, 2007). This may be contrasted with dualism which "was intended to be useful for economies such as those of Egypt, India, and Jamaica. It was explicitly not intended to be applicable to the United Kingdom or northwest Europe" (Fields, 2004).

What microfinance tells us about the development project

Microfinance has received considerable public support in India and Pakistan. This might be partially attributed to the similarities in the nature of poverty in these countries and Bangladesh, the home of microfinance, given their geographical proximity and shared history. In all three countries it has received institutional support as a poverty alleviation strategy (Imran and Ghani, 2009).

Among the harsher critiques[6] of microfinance is that by Milford Bateman and Ha-Joon Chang who oppose the "central role of microfinance in development policy" which they see as an extension of the "neoliberal/globalisation agenda" (Bateman and Chang, 2012). Although informality is not an area which they focus on, their arguments against microfinance draw attention to the microfinance-informality nexus.

The pivotal role of scale economies is heavily neglected in microfinance lead development models. The tendency of microfinance institutions or MFIs to promote large numbers of microenterprises results in high firm turnover. Additionally, they are forced to adopt cost cutting measures to stay competitive. This of course pushes down incomes, wages, profits, and working/life conditions. Moreover, such firms are detrimental for more efficient SME's operating in the same sector, which have the potential to reduce unit costs and be more productive in the long run.

Also crucial, is the problem of adverse selection in the context of lending, which is illustrated by an example from India, where savings are being directed into profitable MFIs instead of scalable alternatives. This is problematic for India's growth prospects as 'average firm size in India is less than one-tenth the size of comparable firms in other emerging economies. The emphasis on microcredit and the creation of microenterprises will only make this problem worse' (Karnarni, 2007).

Informalization may also be promoted by unethical practices as may be illustrated by another example from India related to the retail sector. Here, particularly in the previous decade, MFIs continued to push lending despite knowing the risks of saturation. In 2007 in the state of Andhra Pradesh, the government stepped in to close down a number of MFIs that were found to be putting their own targets ahead of client interests and selling products to poor retailers with firms too small to use and repay the capital efficiently (Bateman & Chang, 2012).

Space constraints prevent us from discussing the other points made by Bateman and Chang (2012), despite their relevance in the context of the microfinance-informality nexus. Nevertheless, from the above at least three conclusions may be drawn. One is that microfinance does not have the propensity to create or assist firms that will make a transition from informal to formal. Another is that microfinance tends to expand informality. Further, the backward and forward linkage discussed earlier, that may be formed by informal firms are not inclined to reach the scale that would make them conducive to sustained economic growth.

Duvendack, Palmer-Jones, Copestake, Hooper, Loke, and Rao (2011) carry out a systematic review to ascertain "What is the evidence of the impact of microfinance on the well-being of poor people?" They find an absence of research[7] confirming that microfinance alleviates poverty and emphasize the need for more robust studies. They are however skeptical about the partiality for the purported gold standard of research, randomized control trials, holding that "current enthusiasm is built on similar foundations of sand to those on which we suggest the microfinance phenomenon has been based." They also point to the need to analyse the reasons behind the gratuitous exuberance for microfinance.

Explanations for the unwarranted levels of support for microfinance have been offered in a number of studies (Bateman & Chang, 2012; Chowdhury, 2009; Karnarni, 2007). These point to a number of factors including its appeal as a business model, its claims about women's empowerment which attracts donor support, and its affinity with the development project in which state failure is best addressed through markets.

In a very recent study on India, Chakrabarti and Sanyal (2015) note that even though microfinance increases financial inclusion, this does not necessarily translate to other development goals, particularly income growth, women's empowerment or investments in education. This may be attributed to a trade-off between social impact and profitability that is a central aspect of the microfinance model.

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[6] A much more detailed version of this critique may be found in Milford Bateman's book on the subject (Bateman, 2010).
[7] Although the overall number of studies on microfinance is large, the issue of weak research design including non-availability of rich and high quality data sets constrains the robustness of their findings (Duvendack et al., 2011).

An important chapter in the favoured narrative about microfinance is about Dr. Muhammad Yunus' experiences in rural Bangladesh. His Grameen model was prompted by a chance encounter in the village of Jobra when he personally repaid the debts of a group of women entrepreneurs. He then proceeded to fashion a group lending model which counters the issue of information asymmetry due to thorough peer monitoring (Chowdhury, 2009)[8].

The issue was problematised when microcredit made way for microfinance in a conversion described as "the schism that took place in the 1990s, when the subsidized Grameen Bank model was effectively abandoned and a completely new commercialized microfinance model" and replaced by what has been termed 'new wave' microfinance (Bateman, 2010). As a result, the product offering was expanded from loans to an array of products including savings and insurance.

This transition carried microfinance to a wide number of countries with large, unbanked, poor populations. This event was bolstered by institutional support. This is evident in the case of Pakistan where the central bank has intervened to facilitate MFIs. This is a useful reflection of how a central bank has a role in the promotion of the development project. Also notable is that the policy emphasis is not on formalization, but on commercialization.

The neoliberal central bank which has evolved over the last two decades is distinct from its historical counterpart which used direct means to support economic sectors (Epstein, 2006). This practice is known as 'selective targeting' or 'industrial policy' and is no longer considered a best practice of central banking, under the assumption that the industrial development should be guided only by market forces. Epstein (2006) points out however, that even the Bank of England and the United States Federal Reserve, which are regarded as the foremost examples of modern central banking, have consistently supported their own financial sectors, locally as well as globally.

Perhaps the most noticeable aspect of the modern central bank is its independence from the government. This has to do with the notion that independent central banks are better placed to control inflation which is the outcome of time inconsistency (Kydland & Prescott, 1977; Barro & Gordon, 1982, as cited in Campillo & Miron, 1997). The State Bank of Pakistan, or SBP, is hence an appropriate example to place microfinance in the context of modern central banking, as it gained constitutional or de jure independence in 1994. As a result, it was relieved of the responsibility of preparing and executing an industrial policy which would compel it to direct lending to selected areas of the economy. Despite this, the SBP presently runs a credit guarantee scheme which is supported financially by the UK Department for International Development or DFID, for the purpose of improving "access to financial services for the poor and marginalized groups and for micro, and small enterprises in Pakistan" (State Bank of Pakistan, 2008).

A few inferences may be drawn from the above. One is that MFIs in Pakistan are assisted by lending policy so that they have an advantage not shared by other sectors. Two, drawing on the observations made earlier; the support for MFIs from the SBP will increase informality. And three, that even though microfinance initiatives may enhance financial inclusion which is a stated aim of such projects (State Bank, 2008), the emphasis of this is on commercialization and not on formalization.

The distinction between commercialization and formalization is especially important in the context of backward and forward linkages which were discussed in the previous section. The ascendancy of backward linkages is probably so because of commercialization, and not formalization, as informal players lack the potential to cross scalability thresholds.

[8] Chowdhury (2009) also notes that the group lending approach has found its way into leading microeconomic texts about the asymmetric information and agency problem.

Conclusions

Shifting perceptions of informality may be attributed to the development project, which is the product of neoliberal thought and globalization. As a result, dualism as espoused by the Lewis Model, where growth flows from the formal economy to the informal economy, came to lose prominence in development thought. More recent studies emphasize the relationship of the informal economy to the formal economy with no clear consensus on whether informality is positive or negative for economic growth.

The concept of linkages is related to this debate; the dominance of backward linkages indicates that informality constrains growth whereas the dominance of forward linkages shows that the informal economy is contributing to growth. The existing evidence suggests that the ascendancy of backward linkages is due to the lack of skills and productivity that characterize the informal economy. This tendency, when placed in the context of high development theory, weakens the argument for development outside a dual sector model. The limited growth-inducing potential of the informal economy validates the dualistic view that development flows from the formal to the informal.

The microfinance based development paradigm may also be critiqued using the concept of linkages. Since microfinance favours the growth of smaller, less efficient enterprises over larger, more sustainable ones, it contributes to the ascendancy of backward linkages. This undermines the capacity to reach the profitability thresholds required for sustained growth.

Despite these shortcomings, and others that have been highlighted over recent years, microfinance continues to receive institutional support. Since the modern central bank is a product of the development project, attempts at formalization are likely to be diverted to commercialization, so informality is likely to continue its expansion. A flawed approach to dealing with informality is reflected in the support for microfinance. Among the deficiencies of this approach is a weak understanding of the informality-poverty nexus. When and if, this is addressed, there will be a need for a new paradigm for tackling poverty and informality simultaneously.

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