

# **The Informal Sector and Institutional Economics**

**By**

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**As in much of Economics, the informal sector is neglected in Institutional Economics. In this Lecture I shall point to some selected cases where this neglect can be costly in terms of our understanding of the problems of development.**

### **I History of Thought Issues in Institutional Economics**

**Much of the recent institutional economics literature start with North (1990), or at most with Williamson (1985).**

**In the field of development economics, most discussion of institutions these days also starts with North, and then jumps to the cross-country macroeconomic empirical literature, the most widely cited of which is Acemoglu, Johnson and Robinson (2001).**

**Professional memory or attention span in Economics is always rather short, but most remarkably so in this case, as North (1990) was immediately preceded by at least two decades of vigorous economic analysis of institutions in developing countries, but primarily in the informal sector.**

It started with the literature on the age-old institution of sharecropping in the early 1970's, followed by a proliferation of analysis of institutional arrangements in rural land, labor, credit, insurance, and some general inter-linked markets. Some of these informal institutional arrangements were theoretically and empirically explained in terms of failures in (or incompleteness of) land, labor, credit and risk markets

By the early 1990's two multi-author edited volumes of essays took stock of (and extended) the previous two decades of rich literature on rural institutions:

- Bardhan (1989)
- Hoff, Braverman and Stiglitz (1993)

Another collection of essays, edited by Nabli and Nugent (1989), applied transaction cost analysis in understanding rural and urban institutions in Tunisia.

There was also a 1989 symposium on institutions and development edited by Adelman and Thorbecke for the *World Development*.

There is hardly any trace of this literature in the recent outpourings on the institutional economics of development.

This is partly due to the neglect of informal institutions often relating to the informal sector—**giving more importance to contract laws or formal property rights than to implicit contracts and informal institutional arrangements.**

## II Definitional Issues

A tendency to equate Informal with Illegal--enterprises or arrangements that operate below the official radar.

Many perfectly legal but tiny enterprises are below the tax exemption or regulatory limit.

They may not pay tax to the government, but are often obliged to pay all kinds of extortionate fees to the local mafia/police.

In empirical work data are collected for the informal sector, often defined rather crudely in terms of enterprise size (no. of employees or value of assets used).

This is associated with low productivity operating below the threshold of minimum scale economies or advanced technology.

How do such low-productivity firms compete with higher-productivity firms and survive? Often made possible by the **imperfections in factor markets**—particularly labor and other household-based inputs.

### **III Property Rights and Beyond**

The imperfections of the credit or capital markets, of course, work against informal enterprises.

**Low Collateral**

**De Soto effect**

**Quite a bit of Empirical Literature now**

**Galiani and Schargrotsky (2010) look at the collateral effect of property rights reform. Among urban squatters in Argentina they find significant effects on housing investment, household size, and child education.**

**A study by Field and Torero (2006) of an urban land titling program in Peru indicates that property titles are associated with some increase in approval rates on public sector loans.**

**But giving formal titles to urban squatters does not always mean banks will find it easy to foreclose in the event of default given the political constraints and the imperfect legal system. Also, inadequacy of collateral is often only one of the many constraints facing small producers in urban slums.**

**Besley and Ghatak (2012), emphasizes this theoretically**

**Somewhat stronger evidence is available from the large micro empirical literature in informal agriculture, showing that secure property rights in land generally improve agricultural productivity, farm investment, and farm earnings.**

## **Large literature using cross-sectional data**

**Banerjee, Gertler and Ghatak (2002), using district average data, and Bardhan and Mookherjee (2011), using farm-level data, both in West Bengal, India, on productivity effects of tenurial security reform**

**Most recently, from a large-scale randomized control trial Goldstein et al (2016) present evidence on a land formalization program in rural Benin. They find that improved tenure security induces a 36 to 43 percent shift toward long-term investment on the treated land parcels.**

**Field (2007) and de Janvry et al (2015) show positive labor supply effects of land titling programs in Peru and Mexico respectively.**

**The institutional macro-economic literature—from North to Acemoglu-Robinson-- has shown how important secure property rights are in encouraging investment and innovations, allowing for the investor and the innovator to reap the harvest of their efforts.**

**Serious identification problems in the cross-country regressions**

But, more importantly, the preoccupation with the formal property rights in this literature has sometimes diverted attention away from **other institutional issues that are important for productivity.**

In history securing property rights for some has often meant dispossessing others. For example,

- The rights of enclosure in England eliminated the traditional land use rights of many poor villagers
- In the nineteenth-century United States ensuring the security of property rights superseded communal tribal rights in land traditionally enjoyed by Native Americans
- In recent years in Africa land-titling programs have sometimes dispossessed women of their traditional farming rights
- In Latin America property rights in land were often historically bestowed on people who were politically influential but not necessarily good farmers. This led to polarization and conflicts with poor peasants, which served neither efficiency nor equity.

In general, when contracts are incomplete, **attempts to enforce private property rights may weaken the mechanisms of prior cooperation among resource users (e.g., of previously common or weakly defined property).**

In particular, a central characteristic of most private property rights is their tradability, and tradability (particularly to outsiders) may undermine the reliability of a long-term relationship among users of a resource.

This is particularly important in the case of informal community institutions that have traditionally managed **village common property environmental resources** (irrigation water, forestry, fishery, grazing lands, etc.).

In Bardhan (2000), a study of 48 irrigation communities in south India, I found that when 'exit options' for villagers improve, that tends to have a negative effect on the traditional informal institutional arrangements for resolving water conflicts and disputes among farmers in the village.

Similarly, the market-enhancing features of securing rights in one market (say, credit) may undermine implicit contracts in related transactions where markets are weak (say, insurance).

Kranton and Swamy (1999) gave an example of how the British introduction of court enforcement of contracts in agricultural credit markets of the Bombay Deccan in the nineteenth century reduced lenders' incentives to subsidize farmers' investments in times of crisis, leaving them more vulnerable in bad times with formal insurance markets largely absent.



## IV Formal Rule-based vs. Informal Relation-based Institutions

Many developing countries in the world have a long history of indigenous **mercantile institutions of trust and commitment** (based on multilateral reputation mechanisms and informal codes of conduct and enforcement) -- examples of such institutions of long-distance trade and credit abound among mercantile families and groups in pre-colonial and colonial India, Chinese traders in Southeast Asia, Arab 'trading diasporas' in West Africa, and so on.

The institutional economics literature suggests that these traditional institutions of exchange in developing countries often did not evolve into more complex (impersonal, open, legal-rational) rules or institutions of enforcement as in early modern Europe and emphasizes the need for such an evolution.

But the dramatic success story of rapid industrial progress in Southeast Asia in recent decades often under the leadership of Chinese business families suggests that more 'collectivist' (or group-based) organizations can be reshaped in particular social-historical contexts to facilitate industrial progress, and **clan-based or other particularistic networks can sometimes provide a viable alternative to contract law and impersonal ownership.**

Many business historians—some of them referred to in the recent account by Greif and Tabellini (2015)—have shown how clan and lineage-based institutions in China have for centuries substituted for weak formal institutions, resolved private disputes, and provided local public goods and services and mutual-aid arrangements.

Even in the last three decades, after economic reform started in China allowing private firms to thrive, what Nee and Oppen (2012) have documented and described as ‘capitalism from below’ is based in general on *guanxi* relations and intra-clan help in finance and protection of property rights from official predation.

In a study of 72 Chinese entrepreneurs in Hong Kong, Taiwan, Singapore, and Indonesia, Redding (1990) shows how through specific social networks of direct relationship or clan or regional connection they build a system dependent on patrimonial control by key individuals, personal obligation bonds, relational contracting, and interlocking directorships.

As Ouchi (1980) had noted some years back, when **ambiguity of performance evaluation is high** and **goal incongruence is low**, the clan-based organization may have advantages over market relations or bureaucratic organizations.

**In clan-based organizations goal congruence (and thus low opportunism) is achieved through various processes of socialization; performance evaluation takes place through the kind of subtle reading of signals, observable by other clan members but not verifiable by a third-party authority. Punishment for breach of implicit contracts is usually through social sanctions and reputation mechanisms. Another advantage of such clan-based relations is flexibility and ease of renegotiation.**

**Of course, as may be expected, the arrangements in these business families and groups are somewhat constrained by too much reliance on centralized decision-taking and control, internal finance, small pool of managerial talent to draw upon, relatively small scale of operations, etc.**

**A major problem of such 'collectivist' systems of enforcement is that the boundaries of the collectivity within which rewards and punishment are practiced may not be the most efficient ones and they may inhibit potentially profitable transactions with people outside the collectivity.**

**So as the scale of economic activity expands, as the need for external finance and managerial talent becomes imperative, and as large sunk investments increase the temptation of one party to renege, relational implicit contracts and reputational incentives become weaker.**

As Li (2003) has pointed out, **relation-based systems** of governance **may have low fixed costs** (given the pre-existing social relationships among the parties and the avoidance of the elaborate legal-judicial and public information and verification costs of more rule-based systems), **but high and rising marginal costs** (particularly of private monitoring) as business expansion involves successively weaker relational links.

## **V Implications for Programmatic vs. Clientelistic Politics**

One downside of relation-based institutions in local politics in delivery of public services: **clientelistic machine politics** and forms of vote-buying—i.e. delivery of votes to brokers or agents of powerful local politicians in exchange of discretionary supply of some goods or services-- in many developing countries (as in the history of local politics of today's developed countries).

Programmatic politics (even when mainly 'pork-barrel') delivers formula-bound public transfers by publicly observable criteria (location, age, gender, ethnicity, etc.) and clearly defined rules enforceable in courts.

**Clientelistic transfers are subject to more informal conditions--discretion of local politicians who have the power of withholding delivery to citizens they think may not have voted for them.**

**In general such clientelism results in some transfers of private goods (jobs, subsidies, handouts) to the poor but harms the cause of investment in long-term pro-poor investments in physical or social infrastructure.**

**Over time national transfer programs (like Bolsa Familia in Brazil) or nation-wide property rights reforms (like PROCEDE in Mexico, a rural land titling program) have weakened the grip of such local clientelism. See Frey (2015) for Brazil and Larreguy, Marshall and Trucco (2015) for Mexico.**

**In US history there is evidence that national programs like Social Security and the New Deal under Roosevelt Administration, by delivering financial benefits directly to the poor, made them less dependent on the clientelistic political machines run by local bosses.**

## **VI How Policy Implications May Change when the Informal Sector is Large**

- **Example from Efficiency-enhancing Policies**

**Trade Liberalization in Manufacturing Literature usually deals with only formal sector data. But such liberalization often leads to an improvement in average productivity through the exit of low-productivity informal forms at the tail end of firm distribution**

**Evidence in Nataraj (2011) for Indian manufacturing**

**Evidence from Dix-Carneiro and Kovak (2017) for Brazil: over the period 1991-2010 trade-displaced workers, after spending some time in unemployment or out of the labor force, eventually work in the (often non-traded) informal sector.**

**So it is not clear that average productivity in the economy as a whole always increases.**

**Also efficiency may increase at the expense of equity (in the usual absence of compensating transfers).**

- **Example form Redistributive Policies**

**At a time of increasing concentration of corporate market power and rampant monopsony in the labor market, the redistributive policy of increasing minimum wages is often suggested.**

**But when the informal sector is large, the writ of minimum wage legislation does not reach large parts of the economy.**

**In any case many in the informal sector are self-employed, for whom policies of helping them in terms of better credit and marketing facilities, infrastructure and extension services are more relevant.**

**The policy of a universal basic income supplement may be more imperative than minimum wages.**

**In developing countries where informal workers often lack benefits, a universal basic income supplement can provide some minimum economic security, allowing them to look for better jobs and entrepreneurial opportunities or for retooling and retraining. This has also the added advantage of providing a common platform for the labor movement that is currently divided, between formal and informal workers, between insiders and outsiders.**

**Whether a country can afford such a supplement will, of course, depend on its fiscal resources and the existing state of its public safety nets. According to a recent IMF estimate for eight countries (US, France, UK, Poland, Brazil, Mexico, Egypt and South Africa), a universal basic income calibrated at 25 per cent of median per capita income will roughly cost between 2 to 7 per cent of GDP, depending on the country.**



