



# Urban challenges: the formal and informal economies in mega-cities<sup>☆</sup>

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There is a sense in which the formal and informal economies in mega-cities are taken for granted. The bulk of the literature focuses on the characteristics and problems of the latter. It is crucial, however, that they should not be examined and analysed as separate entities. Rather, it should be acknowledged at the outset that the activities that are normally considered part of the informal economy are often in one way or another linked to the activities in the formal economy. Other reasons for stressing the interconnectedness of the informal and formal sectors in cities are outlined. Perhaps, the key to policy development is to recognise that both sectors incorporate creativity, entrepreneurial flair, and a general desire to harness human capital in ways that maximises its potential.

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## Introduction

Cities are engines of economic growth and social development; they have sustained industrial and commercial development everywhere (Dogan and Kasarda, 1988; World Bank, 2000; Hall, 2000). They serve a primary economic function as the locations where new forms of economic activity and economic organisation evolve and gain higher value. To an increasing degree, cities are also the key nodes of capital accumulation, reinvestment in new sectors, and focal points of the development of specialized services. As service jobs have become increasingly important in national economies, the importance of cities in economic performance is strengthened (Castells, 1989; Daniels, 1993; Bryson *et al.*, 2004). Both industrial and traditional service activities, along with new services related to banking, finance and communication, constitute the new economic base of cities (Sassen, 1994). The major sources of local government revenue are closely linked to the presence and scale of these activities, through a diverse mix of direct and indirect taxes, property rents and fees. With globalization, competition between cities has intensified and they increasingly battle with each other to attract inter-

national investment (Sassen, 2002). Cities provide economies of scale and agglomeration, as well as the economic and social infrastructure within which many businesses and entrepreneurs are incubated and nurtured. Large cities are therefore responsible for a significant share of national gross domestic product (GDP), as much as 44% (Lima) or 38% (Bangkok) and, as such are major sources for economic and social development opportunities. Even cities in the developed economies make very significant contributions to national GDP—21% in the case of London, for example (Corporation of London, 2001).

## The inexorable growth of mega-cities<sup>1</sup>

The number of people living in cities in the developing world is growing at a much faster rate than in the industrialized world. The pace of urban expansion in the developing world sharply distinguishes the process from its historical precursor in Europe. It took London from 1800 to 1910 to multiply its population by seven, from 1.1 million to 7.3 mil-

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<sup>1</sup>There is no agreement about the population size threshold for mega-city “status”. A population figure of 8 million is one of the most common thresholds (UNDIESA, 1998; Gilbert *et al.*, 1982) but others have used 4 million (Dogan and Kasarda, 1988) or 10 million (World Bank, 2003). The term “mega-city” is also frequently interchangeable with terms such as “super-city”, “conurbation”, “world city”, and “megalopolis”.

**Table 1** The world's largest cities (top 20), 1980 and 2010 (estimated)

1980 (Population, millions)	Rank	2010 (Population, millions)	Rank change 1980–2010
Tokyo (21.9)	1	Tokyo (26.4)	No change
New York (15.6)	2	Bombay (23.6)	+14
Mexico City (13.9)	3	Lagos (20.2)	Outside top 20 in 1980
São Paulo (12.5)	4	São Paulo (19.7)	No change
Shanghai (11.7)	5	Mexico City (18.7)	–2
Osaka (10.0)	6	Dhaka (18.4)	Outside top 20 in 1980
Los Angeles (9.5)	7	New York (17.2)	–5
Buenos Aires (9.0)	8	Karachi (16.6)	Outside top 20 in 1980
Calcutta (9.0)	9	Calcutta (15.6)	No change
Beijing (9.0)	10	Jakarta (15.3)	Outside top 20 in 1980
Paris (8.9)	11	Delhi (15.1)	Outside top 20 in 1980
Rio de Janeiro (8.7)	12	Los Angeles (13.9)	–4
Seoul (8.3)	13	Metro Manila (13.9)	Outside top 20 in 1980
Moscow (8.1)	14	Buenos Aires (13.7)	–7
Chicago (8.0)	15	Shanghai (13.7)	–10
Bombay (8.1)	16	Cairo (12.7)	+2
London (7.7)	17	Istanbul (11.8)	Not in top 20 in 1980
Tianjin (7.3)	18	Beijing (11.5)	–8
Cairo (6.9)	19	Rio de Janeiro (11.5)	–7
Essen (6.3)	20	Osaka (11.0)	–14

Source: Extracted from UN (1999), see also UNCHS (2001a).

lion; this growth rate has been achieved by some African cities within a generation, while many Asian cities have increased fourfold in the same period. In 1950, there were just two cities in the world with a population of more than 8 million, London and New York. By 1990, there were six such cities in industrialized countries, a number not expected to change before the end of the century and in the Third World there were 14 such cities. Using a higher threshold population of 10 million, there were 23 mega-cities worldwide in 2000 and 18 of these were in the developing world. The transition of humankind from rural to city dwellers represents a major, and permanent, demographic shift. By 2010, the total rural population in the world will—according to the United Nations—reach its peak at 3.1 billion and thereafter begin to decline. By 2030, global urban populations will be twice the size of rural populations, and cities will have grown by 160% over the period.

Among the developed countries, only Tokyo will have held its place for 30 years as the largest urban agglomeration in the world (*Table 1*). These larger cities are already huge: Mexico City has over 20 million people. Although ranks may have changed, all the mega-cities (with the possible exception of London), will have experienced population growth, although at a slower rate in the advanced economies (perhaps 0.3% per annum) compared with much faster growth in Asia, where some mega-cities are growing at more than 1% per annum (*The State of the World's Cities, 2001*). Such a rate of growth stretches urban planners, architects, engineers and civic administrators to the very limit, even if resources are plentiful. But in many countries, particularly in Africa and South Asia, resources are very limited and often constrained by the same

forces—low agricultural prices, debt, economic recession, flood or drought disasters—that are driving people off the land and in to the cities. Many of the in-migrants end up in the largest cities where already negligible resources for investment in basic services—roads, water supplies, drainage, housing—are placed under even more pressure. As seen from this perspective, mega-cities present numerous problems, but they also offer economic and social opportunities that may outweigh the disadvantages (*Richardson, 1989, 1993*). Their success at dealing with some of their problems will depend on effective management of their economies, both formal and informal.

### Defining the formal and the informal economy

The concept of a formal economy (or sector) is generally widely understood and generally accepted. It is based on the employment of waged labour within a framework of rules and regulations, usually devised and implemented by the state, on working hours, minimum wages, health and safety at work, or the social security obligations of employers and employees. Jobs in the formal sector are relatively secure and in return for regular wages/salaries, individuals contribute to the public good via taxes on their earnings that are used to provide public services, such as health or education. This is the kind of employment that is generally associated with the mega-cities (and economies) in the developed market economies.

The notion of an informal economy (or sector)<sup>2</sup> is still somewhat contested but is now firmly

<sup>2</sup>Also called the underground, parallel or shadow economy (see for example, *European Commission, 1990*).

**Table 2 Activities in the informal economy**

Legal activities	Tax evasion (monetary transactions)	Unreported income from self-employment. Wages, salaries, and assets from unreported work related to legal goods and services
	Tax evasion (non-monetary transactions)	Barter of legal services and goods
	Tax avoidance (monetary transactions)	Employee discounts, fringe benefits
	Tax avoidance (non-monetary transactions)	All do-it-yourself work and neighbour help
Illegal activities	Monetary transactions	Trade in stolen goods; drug dealing and manufacturing; prostitution; gambling; smuggling; fraud
	Non-monetary transactions	Barter of drugs, stolen, or smuggled goods. Producing or growing drugs for own use. Theft for own use

Source: After Lippert and Walker (1997).

ensconced as part of the development paradigm. Perhaps, one of the best general treatments of the topic is an ILO report (1991) which explores the concept from a number of different perspectives and demonstrates the way in which the informal economy represents a special (or different) mix of challenges to, for example, conventional notions of economic management in cities (see Castells and Portes, 1989). The concept of an informal economy is possibly much easier to grasp than a definition, about which much divergence persists (Losby *et al.*, 2002).<sup>3</sup> There is agreement, however, that it incorporates legal and illegal activities (Table 2) and is a very significant part of the labour force in the mega-cities in the developing world. If definition is difficult, then measurement of the informal economy is even more arduous, because it is a “floating, kaleidoscopic phenomenon, continually changing in response to shifting circumstances and opportunities” (Dicken, 1992: p 447).<sup>4</sup> While the measurement problem is not insignificant, most observers agree that the informal economy is large and growing and it will be an enduring feature of the economy of mega-cities for some time yet (Djankov, 2003).

### Some key activities within the informal economy of mega-cities

Informal commerce and other services, of which itinerant street vendors are amongst the most visible, are symbolic of the informal economy in cities (Jones, 1988; Cross and Balkin, 2000). They sell anything from water to state-of-the-art electronics, providing much needed work that fends off desti-

tuition, introduces some social stability and offers the prospect of new economic opportunities and a better quality of life (Mingione, 1996). There are thousands of street vendors in all the mega-cities and they are one of the clearest indications that capitalism does not need to be taught or that the poor and the migrants can be entrepreneurs without the need to be wealthy. In most of the mega-cities of the developing world, as well as some in the advanced economies, snack vending is a highly visible activity that serves a useful social purpose. In the Asian mega-cities, pedicab drivers are a vital, if unregulated, component of the urban transport system. There are numerous small artisans who add to the local economy by producing crafts, food products, furniture, or repairs of all kinds in the mega-cities of the developing world. The changing structure of urban societies, such as the increased incidence of two-income, full-time worker households in the advanced economy mega-cities, has created significant demand for household workers. In some cases, this involves international short-term migration from less developed countries into the mega-cities (International Organisation for Migration, 2003). Home-based workers (operating as unincorporated enterprises) are also part of the informal economy; they are either dependent in that they work outside the establishment that buys their products or they do not employ workers on a regular basis, or they are independent and work in their homes and deliver their services or products to prospective buyers (World Bank, 2001). This group of informal activities is diversifying to include individuals providing computing and telecommunications services such as software installation, web site set up and design, or technical support for software and hardware. Such work is not necessarily poorly paid but it generates a significant volume of unregistered economic activity.

In many mega-cities in the developing world, significant numbers of workers—men, women and children—are employed in construction in the formal sector, while they themselves have only an informal connection to the local economy (ILO, 2001). They sometimes camp in the buildings they are working on, and move from site to site. The

<sup>3</sup>For the purposes of this paper, the informal economy includes “all income-earning activities that are not regulated by the state in social environments where similar activities are regulated” (Castells and Portes, 1989: p 12; see also Williams and Windbank, 1998).

<sup>4</sup>There are several direct and indirect ways of measuring the informal economy, as well as models that can be used to estimate its size as a function of the variables that are assumed to influence it e.g. unemployment, official working time, the level of taxation, or the costs of government regulation. None is entirely satisfactory and decision makers should be wary of using estimates based on one method (see for example, Schneider and Enste, 2000).

**Table 3 Incomes, informal employment and unemployment, by world region, 2000**

Region	GDP per capita (US\$)	City product (US\$)	Household income (US\$)	Informal employment (%) <sup>a</sup>	Unemployment rate (%) <sup>a</sup>
High income countries	22,501	22,103	26,273	3 <sup>b</sup>	8
Asia Pacific	4742	6182	9101	33	8
Latin America	3350	3226	5623	39	13
Arab states	2752	3170	5850	65	11
All developing	2670	2988	4761	37	12
Transitional	2541	2905	3591	21	9
Africa	441	729	1637	54	23

*Source:* Extracted from UNCHS (2001b).

<sup>a</sup>There has been some confusion in the distinction between informally employed (employed in unregistered enterprises) and unemployed, which relates to those actively seeking work in the formal sector. Quite often, formally unemployed people will work in the informal sector, so there may be double counting.

<sup>b</sup>Not significant.

nature of their work subjects them to frequent injury but they are unregistered and have no access to social or medical services. Indeed, substantial parts of the urban area of mega-cities, in the developed world especially, have been constructed by informal labour. The materials used may be unconventional but such construction, much of it in the form of housing, represents significant investment over and above that made by city or national governments. It is socially important because the least privileged in urban society can begin to emerge, however slowly, as the new property class with ownership rights and a stake in urban society and its improvement.

Manufacturing activities are also a major part of the informal economy of cities. Such industrialists can be divided into two groups: formal industrialists who informalize parts of their production activities to avoid tax or the costs of regulation; and informal industrialists and artisans who are employed illegally in textiles, ready-to-wear clothing, or furniture-making or who set up craft industries in their own homes or at small workshops shared with family and relatives (Gherssi, 1997). Those involved do not get paid or get paid indirectly by being taught a particular skill or trade. In this way, the informal sector generates numerous micro-enterprises.

Whatever their role in the informal economy, the core requirement of individuals and firms is a willingness to work extraordinarily hard, to be organised, to be able to identify opportunities, and to be willing to take risks in an environment that may be “informal” but which is no less competitive than the “formal” economy of a mega-city. As Ghersi (1997) observes: “the streets of Latin America have become the best business schools available”!

### Economy and employment in the mega-cities

Ultimately, the reason why people come together in mega-cities is for wealth and job creation and, in general, incomes and productivity are higher in urban areas (Table 3). Average city product per

capita is always higher than national product per capita. The informal employment sector tends to vary strongly with city development levels, ranging from about 54% of all employment in Africa to 3% or less in the high income countries (HIC) (although informal employment figures tend to be underestimated and concealed in developed countries because of compliance requirements). Unemployment rates tend to be rather meaningless in countries with high levels of informal employment, but unemployment also falls away with increasing development levels.

The sheer population size of the mega-cities ensures that their economies generate significant demand for labour, both to enable them to function on a day-to-day basis and to enable them to capitalise on the economies of scale and agglomeration that nurture new businesses and enable established ones to grow.<sup>5</sup> However, in many cases (especially the mega-cities in the developing world), the supply of labour far exceeds demand, which is itself linked to incomes and associated purchasing power. It remains clear that the largest gaps between developed and developing countries are in incomes, product and capital, and in the forms of consumption and investment that this permits. Household income is about 17 times as great in the HIC as in the bottom quintile of cities, and city product and GDP per person are 37 times as large (UNCHS, 2001a). The majority of “in-comers” as well as many of those already resident in these cities have little or no income or skills that allow entry into the labour market to be a realistic possibility.

<sup>5</sup>The spatial dimension of employment in the mega-cities should not be overlooked. In many of the mega-cities affluent central business districts (CBDs) dominated by formal economy infrastructure and employment exist side by side with slum and squatter settlements where the informal economy provides some inputs (street vending, office cleaning, transport) to the CBD as well as functioning in its own right. In some mega-cities, jobs are moving from the CBD to the suburbs and exacerbating problems of access to job opportunities by low income households (see Wilson, 1996).



Under-employment, unemployment, “mis-employment” (the full time retention of non-productive employees) and the growing absorption of women into formal employment are typical of the labour situation and a fundamental feature of the economies of mega-cities; they are both a cause and a consequence of urban poverty (*The State of the World's Cities*, 2001; Baharoglu and Kessides, 2001; O'Brien *et al.*, 1998; Jargowsky, 1997).<sup>6</sup> The proportion of “urban poor” in many cities is between 30% and 60%, and in some it is spectacular: in Addis Ababa, 79%; in Luanda, 70%; in Calcutta, 67%. Many of the poor live in the favelas, barrios, bastis and bidonvilles that are a prominent feature of mega-cities in the developing world, housing an estimated 1 billion people in 2000. In order to be able to remain in these cities, the poor require a survival strategy, and an informal sector that incorporates the different types of labour situation cited above is one of the principal responses.

### **The seamlessness of the formal and informal economy in mega-cities?**

There is a sense in which the formal and informal economies in mega-cities are taken for granted: the bulk of the literature focuses on the characteristics and problems of the informal economy (see for example, Sethuraman, 1981; ILO, 1991; Bangasser, 2000). It seems crucial, however, that they should not be examined and analysed as separate entities. Rather, it should be acknowledged from the start that the activities that are normally considered part of the informal economy are often in one way or another linked to the activities in the formal economy (see for example, Gaber, 1994; Sassen, 1989). Some of the linkages between the informal and the formal economies have been identified by Portes and Sassen-Koob (1987). These include informal supply chains whereby informal workers supply inputs to local buyers who then sell the product to a wholesaler, who acts as the link with the formal sector, and informal marketing chains that are controlled by intermediaries dependent on formal economy firms but acting as channels of information about the products and services of numerous informal merchants or street vendors. Subcontracting in manufacturing often relies on work performed by home- or outworkers who

appear to be self-employed but are actually very dependent on work provided by large firms in the formal economy.

A simple example of this is the global production chain for products such as coffee, bananas, electronic goods such as computers, or sports footwear which has activities firmly embedded in the formal economy (orchestrated from headquarters often located in some of the world's leading mega-cities) at one end of the chain, while at the other end (or the bottom) the share of the return (from the final sale price) is so low that workers can only survive by supplying their labour outside the norms and practices associated with the formal economy (Gereffi and Miguel, 1994). Home workers are another example of informal workers working for formal enterprises. Parts of the fashion garment industry are firmly anchored by unregulated or poorly regulated sweatshops and home workers who sew, stitch and pack for low piece rates and no social benefits (Portes and Haller, 2002; Gereffi, 1999; Lund and Srinivas, 2000). “Middle men” are clearly crucial to the operation of these production chains and this has two important consequences: first, there is less accountability on any one link in the chain to provide decent work and, second, those at the lowest level (or the start) of the chain receive very little return relative to the final sale price of a commodity or a good. Another example is the combination of the formal and the informal that characterises Chinese business networks (or “bamboo networks”) in which personal relationships based on trust and reciprocity are the most important mechanisms shaping cooperative strategy therein (Yeung and Old, 2000).

There is also tendency to think of the formal and informal economy as primarily a distinction that is appropriate to analysing the economies of mega-cities (and national economies more generally) in the developing world and in the transition economies. Yet, a description of activities in the informal economy as typically represented by a fireman with a second job as a painter and decorator, a gardener who regularly maintains the gardens of several clients (perhaps for private individuals and companies) in return for “cash in hand” which is not declared to the tax inspector as earnings, paid domestic workers (Cox, 2002), a street vendor selling handbags or perfume, or a drug dealer completing a sale at a night club, can apply just as much to mega-cities in the developed economies (Greenfield, 1993; Portes *et al.*, 1989; Leonard, 1998).<sup>7</sup> This characterisation of informal activities again reveals the difficulty of treating the formal

<sup>6</sup>Urban poverty is a multidimensional phenomenon. The income dimension is a function of employment insecurity, unskilled work, lack of qualifications, inability to hold down a job because of bad health, lack of access to job opportunities and the extent of dependence on cash for the purchase of essential goods and services. Health and education poverty, personal and tenure insecurity, and disempowerment are the other, interlinked, dimensions (see <http://www.worldbank.org/urban/poverty/defining.html> for a detailed elaboration).

<sup>7</sup>There are some 48 million persons working illicitly in the European OECD countries and their productivity is likely to be considerably higher than those in the official economy. Informal labour has been estimated between 30% and 48% of the official labour force in Italy (Djankov, 2003).

and informal as separate. The informal economy does certainly include illegal activities but it also includes unreported income from the production of legal goods and services (Schneider and Enste, 2002).<sup>8</sup> Given that those engaged in the informal economy are, by definition, anxious to be invisible from the prying eyes of the authorities, it is enormously difficult to gauge its true size, but estimates by the IMF for the period 1988–2000 suggest that it accounted for 14–16% of GDP in 21 advanced economies (all members of the OECD) (Schneider and Enste, 2002). For the period 1999–2001, Italy and Greece had informal economies of 27% and 30% of GDP, respectively. Next come the transition economies where the informal economy proportion of GDP averaged 21–30% between 1988 and 2000, with Russia at 44% and Georgia at 64% in 1998–1999. The latter is modest compared to some of the developing countries where IMF estimates for 1998–1999 show that the informal economies of Nigeria and Egypt were equivalent to 77% and 69% of GDP, respectively. Hong Kong and Singapore had informal economies of only 14%, but Bolivia at 67% had the largest informal economy in Latin America. It has been estimated that 60% of person-hours worked took place in the informal sector of Peru during the mid-1980s (De Soto *et al.*, 1986). Growth in the size of the informal economy tends to push up the demand for currency (since most of the transactions are in cash), reduces labour force participation rates and the number of hours worked in the formal economy. It is not clear, however, whether growth of an informal economy depresses GDP. There are those who contend that a reduction in the size of the informal economy will increase tax revenues and stimulate a rise in public spending (especially on public services and infrastructure associated with production), leading to rise in overall economic growth. The converse view is that the informal sector is more competitive and efficient than the formal sector, so that an increase in the latter will retard the overall growth rate.

It is also the case that some elements of the informal economy, both within the mega-cities and beyond, are extremely well organised and use the formal economy to distribute product or to deposit income. A good example is the trade in illicit drugs, which has actually been made easier by world trade liberalisation and has generated billions of dollars annually for money laundering and investment (UNODC, 2003). In the late 1990s,

international trade in illicit drugs was valued at US\$ 400 billion or about 8% of world trade (United Nations, 1999). Global supply chains use everything from commercial passenger jets that can carry shipments of drugs, such as cocaine, that are worth US\$ 500 million in a single trip, to custom-built submarines that ply the waters between Colombia and Puerto Rico. Drug smugglers use complex financial structures and elaborate cross-ownership arrangements that blur the distinction between formal (legitimate) and informal (illegitimate) enterprises. Although there are measures designed to prevent money laundering, deposits are made with financial institutions that may subsequently be used to purchase goods and services that unwittingly benefit other sectors that are also embedded in the formal economy. Few countries are free of the practice of helping individuals and companies hide the proceeds of drug trafficking, gambling or tax evasion; at upwards of US\$ 2 trillion, global money laundering accounts for some 5% of the world's annual gross national product (Naim, 2003). The mega-cities are major nodes in international drug trafficking and some are major centres for money laundering, because they possess the necessary financial infrastructure and onward telecommunications and transport links to other financial centres worldwide.

Intellectual property is another area where there is a dynamic interface between the informal and the formal economy. Technology has boosted the supply and the demand for illegally copied products, such as computer software, music, films and luxury goods, such as expensive watches or designer clothes. At the end of 2002, some 900 million music files could be downloaded free on the Internet—that is, almost two and a half times more files than those available when Napster reached its peak in February 2001 (Naim, 2003). Such “transactions” undoubtedly contravene national and international copyright laws that are flouted by “illegal” suppliers but they could not exist without the telecoms, financial, marketing and other infrastructures within the formal economy. Naim (2003) cites the example of a prominent Swish watchmaker taking the view that the person purchasing a pirated copy of one of their US\$ 5000 watches for less than US\$ 100 is potentially a future client that some day will want to own the real thing instead of a fake. A similar line is adopted by the major international music industry supplying CDs to markets, such as in China, where sales of pirated music far outstrip formal market sales but when disposable incomes rise, the industry hopes that the balance will shift towards copyrighted sales. A final example is the US adult film industry which until recently was part of the “invisible” or “underground” economy in states such as California (especially the San Fernando Valley area of Los Angeles). More than 11,000 adult movies were pro-

<sup>8</sup>This highlights a definitional problem in that many economists would define the informal economy as the system of exchange outside state-controlled or money-based economic activities. It therefore only comprises activities such as barter, mutual self-help, street trading, or odd jobs. In these terms, most of the world's population will be participating in their local informal economies.

duced in the US in 2003 creating a US\$ 10 billion industry that is bigger than the NBA, the NFL or Major League Baseball combined ([ABCNews.com, 2004](#)). The production companies market and distribute the movies through video stores and over the Internet. Major international hotel chains and leading cable/satellite entertainment corporations derive significant revenues (more than US\$ 1 billion in 2003) from adult films, but it is rarely possible to identify these income streams in the corporate accounts that must be lodged annually with the regulatory authorities. These examples help to underline the way in which behaviour that is deemed to be deviant and therefore associated with the informal economy can be re-appraised in a way that facilitates a shift to legality (the formal economy). The key point is that commercial demand actively, even if unwittingly, provokes such a reappraisal.

There are other reasons for stressing the interconnectedness of the informal and formal sectors in cities. The notion of an informal economy might suggest that participants are not aware of or exposed to the rigours of the “market”. Irrespective of which individual or business is part of the informal economy, they are still aware of market forces, both within that economy and at the interface with the organisations, institutions and individuals that are part of the formal economy. Although many of the transactions within the informal economy may not be within the purview of official statistics or known to the tax authorities, they are still subject to the market rules that determine the price etc. of the good or service that the informal sector transactions might involve. There is also an awareness of “markets” and other ways of life created by access to the media, advertising and the physical artefacts of the formal economy, such as the office buildings, mobile phones, or expensive cars occupied or utilised by those who belong to the “formal sector” of the economy.

Whether individuals are part of the formal or the informal sector, markets are ubiquitous in other ways (although participation in them may vary), ranging from the local “super-market”, to street markets where goods are sold, to the “labour market”, the “stock-market”, the “capital market”, and even the “world market” for labour.<sup>9</sup> A full cross section of the city population: under-employed, employed workers, merchants, entrepreneurs, financiers, professionals, and those not part of the labour market because of their age, for example, participate in these formal economy activities. Some, however, are unemployed, some have other occupations that are not sufficiently remunerative, and others have difficulties selling

their products and maintaining the profitability of their enterprises. Indeed, it seems that more and more people have precarious and insecure working situations, and also, that more and more people combine formal and informal work in order to secure enough income.

### **Graduating from the informal to the formal economy: social progress?**

Does social progress call for a graduation from the informal to the formal economy? The words at hand, “informal” and “formal”, “transition”, “graduation”, “passage”, suggests a progress, a linear, difficult and yet irreversible and desirable movement from one stage of economic and social arrangements to another, from a traditional and imperfect state of the economy to a modern and less imperfect state. This perspective is closely linked to the perception of development that has shaped national policies and the discourse of international organisations since the 1950s. Is there a need to reconfirm this vision and restate that economic modernisation, and therefore the progressive graduation of the informal into the formal economy, is both a necessity and a component of social progress?

A healthy economy and society is made of a large variety of activities and institutions, with different uses of human skills and techniques of production and organisation. The juxtaposition in time and space of this vast array of activities with tight and loose linkages with large markets, including the “global” market and the associated regulatory apparatus, should offer opportunities to people with different outlooks and talents, should lessen rigidities, and should be a source of creative tensions ([Makaria, 1997](#)). Such richness, combined with the introduction of rules, regulations and institutions, is seen as a prerequisite for the passage from a “traditional” to a “modern” mega-city economy. It may be more realistic, however, to focus on nurturing the coexistence of such diversified economic structures rather than assuming a linear transition? Perhaps the concept of “formal” and “informal” activities/economies could then be abandoned?

By observing and experiencing the formal sector, those who are functioning as part of the informal economy, however poor and deprived, acquire needs and wants for things that will improve their lives. From the street-hawker to the small entrepreneur, a growth of turnover or increased profits offers the prospect of a higher income and the ability to exercise options for better housing, sanitation, transport or the quality or stability of life more generally. The aspirations of those embraced, whether voluntarily or involuntarily, by the informal economy are not in question; the issue is how

<sup>9</sup>Some ways of thinking beyond the ubiquity of the market are explored in [Friedland and Robertson \(1990\)](#).



to develop markets and enable them to function more effectively as a means of fulfilling individual and collective socio-economic goals. What would seem particularly relevant is a better knowledge and understanding of the living conditions and problems of people in both the “formal” and “informal” sectors and a critical appraisal of the commonly accepted view that progress, economic as well as social, implies a progressive graduation of the informal into the formal economy. How should this be approached; whom should be targeted; should certain types of economic activity be encouraged because they are a “safer” or more reliable route from one economy to the other; and what are the measures that are needed to assess whether the changes that are taking place are advantageous and, if so, to whom?

### **Moving from the informal to the formal economy: barriers to entry**

Using evidence from macroeconomic and micro-economic models, and data from several OECD countries, [Schneider and Enste \(2000\)](#) suggest that the major drivers of the growth and size of the informal economy are an increasing burden of social security and tax payments, increasing regulation of formal economy labour markets, and wage rates in the “official” economy. In broad terms, the bigger the difference between the total cost of labour in the formal (or official) economy and after-tax earnings from formal economy work, the greater the incentive for employers and employees to avoid this gap by participating in the informal economy. Individual workers will be mobile between the formal and the informal economy depending on the level of net wages; if net wages fall they will work more in the informal economy and vice versa. Countries (and cities) with more regulation<sup>10</sup> of their economies have larger informal economies; a one point increase in a regulation index (on a scale from 1 to 5) for a sample of 84 advanced, transition and developing economies is associated with a 10% increase in the informal economy ([Schneider and Enste, 2000](#)). Economies with strong and efficient government institutions will tend to have smaller informal economies, even if this means higher tax rates—ineffective and poorly managed tax regimes encourage participation in the informal economy.

If it is assumed that the ambition of the majority of those that are part of the informal economy is to make the transition to the formal economy, it is important to consider the main barriers to entry into the latter. Most of the barriers are insti-

tutional, financial, or regulatory. For example, the institutional support and enhancement of the market environment and the way that the economy functions in the mega-cities is either very limited or not really present at all. Such institutions may be formal and/or informal but there is no universal template that can be applied everywhere; institutional structures and facilitation have to be tailored to accommodate the business traditions and practices within different cultures and different societies (within the same mega-city or between cities in different countries). Even where they exist, the necessary institutions may not be equally accessible; those operating in the informal sector tend to be less well informed about the options or lack the confidence to use them. If they do choose to do so, they will often be faced with the high transaction costs created by the rules and regulations governing the operation of the self-employed or firms in the formal sector. The administrative systems (public and private) that manage and ensure compliance with the tax, health and safety and other rules are often inefficient and even corrupt and effectively obstruct the transition of economic activities from the informal to the formal economy.

In most cases, the businesses that are attempting to move into the formal sector require some form of finance to cover the costs of acquiring suitable premises, the upfront costs of insurance for premises and equipment (assuming that insurance is available to purchase), or the costs of installing new equipment. Since the informal sector thrives for the most part without an adequate system of property rights or without the need to occupy premises of one kind or another to conduct business, accumulating or raising the capital that enables business development is very difficult. Access to “normal” credit lines is restricted and, combined with the general reluctance of the formal sector credit market to provide funds to entrepreneurs in the informal economy, there is no alternative but for informal businesses to use the informal sector credit market. This inevitably means punitive interest rates, unless self-help schemes such as credit unions can be set up. The transition to the formal sector also requires access to legal services (to legitimise and enforce business contracts or property transactions for example) but cash-poor micro-enterprises do not have the financial resources and facilities to enable access at a realistic cost. The way in which labour markets work in the mega-cities is also a consideration. Many individuals who are part of the informal economy, as well as those planning to migrate to the cities in chase of non-existent jobs, do not possess the education, skills, and knowledge to be able to compete with workers already in the formal economy or to be able to function as part of it. Illiteracy is still widespread in some countries;

<sup>10</sup>Government regulations include labour market controls and rules, licence requirements, restrictions on the employment of foreign labour, and trade barriers.



many workers and entrepreneurs are therefore unable to compete for existing formal sector jobs, or are ill-prepared for making the transition to operating a business in the formal economy. These effects will also discourage the creation of new employment opportunities based on a demand for an educated and skilled workforce. Some of these difficulties are compounded by labour market rigidities that have to be addressed at the local level, insofar as they are a function of social and cultural mores.

While there may be barriers to entry, there are of course numerous examples of individuals and firms making the transition from the informal to the formal economy. A service industry example is provided by Zhou (2000) as part of a study of the development of Chinese-owned producer service firms in Los Angeles. Although poorly documented, immigrant-operated producer services such as the informal financial organisations (rotating credit systems) used to facilitate the financial needs of ethnic businesses have existed for some time in North American cities. Zhou (2000) cites studies showing the existence in Chinese communities of firms engaged in accounting, legal services, real estate, as well as financial services. Such firms were very small, relatively few, informally structured, and almost exclusively confined to the ethnic communities that they served. There was very little interaction between these firms and the mainstream economy/society: Chinatown in Los Angeles was very much segregated from the rest of society in the period before the early 1970s. From the mid-1970s onwards, the ethnic identity of Chinese producer service firms in Los Angeles has been retained but rapid growth of new Chinese immigrants and the increases in capital that they brought with them made it very difficult for the isolation from the formal economy of Los Angeles (and beyond) to be sustained. The growing sophistication of the Los Angeles Chinese community created demand for better quality producer services; some of the relevant knowledge and expertise was available from within the Chinese business community but a good deal was only accessible via mainstream firms and organisations. Links have therefore been established accordingly and the firms involved are now regulated by mainstream institutions. It is likely that similar processes are happening in other cities (Daniels, 2003).

### **The formal and informal economy in mega-cities: changing the balance?**

While the economies of mega-cities should be viewed as entities rather than divided between the formal and the informal, in practice there is an assumption that the former can look after itself (via the market and appropriate regulation/dereg-

ulation) while the latter requires more intervention. Assuming that the informal economy will be a permanent feature of the economy of mega-cities for the foreseeable future, the issue is one of balance. As a general rule, the larger the informal economy, the lower the revenues to the city government or to the state and this, in turn, reduces the quality and the quantity of public goods and services. As a consequence, tax hikes are imposed on firms and individuals at a time when infrastructure and services are deteriorating due to declining revenues. Given that one estimate is that some two-thirds of the income earned in the informal economy is immediately expended in the formal economy (Schneider and Enste, 2002), it is worth trying to maintain this boost to overall economic growth. Thus, while the authorities may legitimately wish to reduce the size of the informal sector, they may actually do so at the peril of a city's GDP. Successful shifts from the informal to the formal economy seem to occur in countries (and, we may ask, their cities) with "higher tax revenues achieved by lower tax rates (resulting in greater compliance), fewer laws and regulations combined with consistent enforcement" (Schneider and Enste, 2002: p 3).

For some, the ultimate objective is to devise strategies and policies that will help to move firms and individuals into the formal sector, but for others it is not an either/or issue, rather it is to create a dynamic and supportive environment for both sectors. This is the only way to raise the quality of work, to improve working conditions, or to improve productivity without losing the flexibility of the informal economy or the fluidity (ability to move in and out of either sector) that helps to retain the overall performance level of the mega-city economy as a whole. Such an analysis is couched in terms of addressing a problem within the economy of mega-cities; globalisation and the locational behaviour of transnational corporations (often involved with the production chains mentioned earlier) mean that both the formal and informal economies are linked between mega-cities as well as within them. Intra-city economic strategies must therefore be aligned with, or somehow build in, the effects of international trade agreements or the flows of unskilled and skilled labour between countries and different continents. Some form of global alliance between cities, transnational corporations, national governments and NGOs may be one way of addressing this aspect of the problem.

Perhaps, the key to the policy approach is to recognise that both sectors incorporate creativity, entrepreneurial flair and a general desire to harness the human capital in ways that maximises its potential. The mechanisms for harnessing these are more refined and accessible to individuals and firms in the formal economy. This is much less the case in the informal sector and support should per-

haps be biased in that direction. It will suffice here to identify some general policies; the details and priorities will very much depend on, for example, the aims and objectives of individual mega-cities or the scale and contribution of the informal economy to economic growth. A “one strategy fits all” approach will never be sustainable because of the diversity of the enterprises and needs within the informal sector. Mechanisms for enabling targeted credit, micro-finance, municipal bond markets and micro-insurance schemes that accommodate the realities of setting up or of doing business in the informal economy would enable higher start-up and business survival rates. Offering “golden hellos” in the form of tax exemptions or tax reductions for a limited period of time for newly established micro-businesses would also improve the chances that they survive the critical early phases of doing business. The latter would also be helped by minimising bureaucracy, in the form of more streamlined and straightforward business and employment regulations/procedures. The installation of appropriate infrastructure, especially highways, electricity, and telecommunications, must also be a priority (UNCHS, 2001a) but this must be linked with mechanisms for facilitating access (perhaps by subsidising charges) so that informal sector businesses can begin to reach the markets or interact with clients in ways that make them indistinguishable, in an increasingly virtual business world, from their formal economy counterparts. The UNCHS (2001a) highlights the benefits of creating “enabling frameworks” within which infrastructure may be provided, for example, via community and user provision, public ownership contracted out to the private sector, or public ownership and operation by commercial parastatal organisations of government departments. Again, needs will vary according to the baseline situation in individual cities; investment in modest, relatively low cost structures suitable for conducting a business such as a shop may provide the necessary security and stability to foster integration between the informal and the formal (Dewar and Watson, 1990).

But reducing red tape and facilitating access to modern infrastructure is of little use unless potential entrepreneurs or employees have the necessary skills; training and business development advice/services are also central to a dynamic informal economy (Fluitman, 1989). These are just some of the possibilities, but whatever the policies there will also be a need to set up organisational and representational mechanisms for co-ordinating, informing, disseminating, and protecting the interests of those seeking to move upward and out of the informal economy in the mega-cities. There also needs to be sustained political commitment in the mega-cities to devising the most appropriate strategies and policies to maximise the synergies between

the formal and the informal economies. In any event, it is clear that improving the productivity of the mega-city economies requires action at national and city levels and it is a relatively new challenge which urban government, in particular, cannot afford to ignore.

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