# INFORMAL SECTOR ALTERNATIVES TO ECONOMIC INSTITUTIONAL PROVISIONS IN INDIA

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## Introduction

Informal sectors are generally stigmatised as unproductive and unmanageable, undermining governance and rule of law. India presents a case in which the informal sector is more dominant than its formal counterpart, employing approximately 92 percent of the workforce (ILO India Labour Market Update, 2017). Despite this, for "Midnight's Children", living standards have doubled over forty years since the 1980s. Midnight's grandchildren are expected to experience further five- or six-fold improvements in their lifetimes (Subramanian, 2007). This raises the question of the significance of the informal sector in the rapid economic growth of India.

The focus of this paper is on the economic institutional services that the informal sector can provide and whether these are preferred to formal institutional provisions. Results suggest that the informal sector can indeed provide effective alternatives. Additionally, even when informal sector alternatives are found to be inadequate, in some cases, they are still preferred. This not only has significant policy implications but also suggests that the role of the informal sector should not be neglected in institutional analysis. Table 1 (see Appendix) summarises the findings, noting which formal institutional provision each informal sector activity provides a solution for.

This paper begins with an outline of the theoretical background regarding institutional theory and the informal sector, followed by a discussion regarding the methodology. It then explores the three informal areas of activity that the literature has suggested provide amongst the most effective alternatives to economic institutional provisions. These are collective, financial, and entrepreneurial activity.

## Theoretical background

The extensive search for effective tools of development has unsurprisingly provided several conflicting answers. Central amongst these, institutional theory, popularised by Acemoglu and Robinson (2013), emphasises inclusive political and economic institutions as prerequisites for long-run development. However, this has proven insufficient in explicating the case of India, where high growth rates have been sustained despite a decline in the quality of economic governance from 1957 to 2005 (Subramanian, 2007).

"One of the abiding puzzles in development economics is the remarkable failure of third world governments to deliver public goods to their people" (Banerjee and Somanathan, 2001), despite widespread consensus that interventions are worthwhile. This failure has been proven to extend to poverty-alleviation, financial service provision, property right enforcement, and social protection. While informal sectors are often argued to cause vulnerability for workers, due to, but not limited to, low human capital base, negation of social security, and rejection of minimum wages, this very sector in India takes on the role of providing alternatives to formal economic institutional provisions and occasionally goes beyond this to facilitate social progress for previously marginalised groups.

## Methodology

While one option would be to search for the main failures of economic institutions and examine whether the informal sector has been able to provide substitutes, this review examines effects of the principal informal sector activities to allow a parallel study of socioeconomic effects. Therefore, if necessary, socioeconomic impact evaluation is prioritised over a comprehensive study of informal sector substitutes for additional institutional provisions.

It should also be noted that there is a much broader scope of research for analysis beyond these three areas of informal activity. However, the objective of this essay is to demonstrate the importance of the role of the informal sector in providing institutional services. This is achieved in an introductory analysis limited to collective, financial, and entrepreneurial activity. An outline of the informal sector activities discusses can be found in Table 1 (see Appendix).

As several debates have emerged between schools of thought, on the roles of the informal sector and the effectiveness in playing these roles, so have corresponding definitions. Definitions from the dominant schools of thought are as follow:

1. The *Dualist* school defines the informal sector as distinct from and not related to the formal sector, providing a safety net for the poor.
2. The *Structuralist* school emphasises marginal characteristics of the informal economy as microenterprises reduce input costs, leading to competitiveness of larger firms.
3. The *Legalist* school highlights the role of micro-entrepreneurs that choose to operate informally to avoid costs associated with formal institutions (de Soto, 2000).

This review analyses the literature in the field by utilising and often integrating, this variety of definitions.

**Informal Collective Activity**

Local cooperation and collective action have been used effectively across India in public good provision and management, employment creation and poverty reduction. Narayan-Parker, Pritchett and Kapoor (2009) provide a qualitative analysis of successful collective activity as a response to state and market failure in India, emphasising the centrality of family. In fact, when asked about institutions that have driven asset accumulation, over 80% referred to families; the inherent trust, unity and solidarity allows self-sacrifice, and the family unit provides pooled economic resources that not only provide an alternative to the traditional welfare system, but also deliver employment opportunities, and remittances Estrin & Prevezer, 2011). Remittances particularly have been found to provide an opportunity for progression for the community at large as family members invest in local businesses.

Whilst moving out of poverty is often done as a family through pooled resources, results show a negative association between propensity for collective action and movement out of poverty. This implies that collective action is primarily a means of coping with poverty rather than leading to prosperity. Hence, group solidarity is particularly important for the chronic poor, perhaps as they are less able to access economic resources. The importance of community for the poor is also implied in a study by Barnhardt, Field and Pande (2015), where highly subsidised suburban housing provisions for slum-dwellers saw low take-up rates, high exit rates, and no improvements in human capital, family income, or tenure security. The importance of community is evident, as the only negative effects detected were reduced social networks ties.

An influential early model developed by Olson (1965) proposes that when incentives to free-ride are sufficiently high, efforts are sub-optimal as group sizes increase, and therefore many fail to organise themselves to provide public goods. However, further research has found many cases in which this zero-contribution thesis does not hold. Ostrom (2000) shows the ability of local groups to cooperate to manage common property resources and avoid overexploitation. Gooptu (2000) builds on this, using a model that goes beyond individual representation to collective self-representation resulting in successful self-organisation of previously marginalised sex workers in Calcutta, despite internal fragmentation and social constraints. Large-scale community-driven development was also prompted by the lack of institutional cover, administrative capacity, and resources to provide adequate infrastructure and services in Chennai (Dahiya, 2003).

## Informal Financial Activity

### Savings and Credit

Credit rationing by formal financial institutions provides opportunities for MFIs when there is high demand for credit from constrained households (Chaudhuri & Cherical, 2012). This has proven true for the majority of India (Swain, 2002) and indeed the developing world. Armendariz and Morduch (2010) examine how self-help groups provide valuable solutions to behavioural imperfections in savings; as members are often from a particular ethnic group, social bonds act as enforcement mechanisms. This extends to rotating savings and credit associations (ROSCAs) in India (Ambec & Treich, 2007). Fishman, Parvisini and Vig (2017) present further evidence that cultural proximity between lenders and borrowers, including shares codes, language or religion, mitigates information frictions and improves the rate of default and quantity of credit.

A theoretical model by Siwan, Baland and Moene (2003) suggests that long-run sustainability of ROSCAs is improbable when social sanction systems are ineffective, by predicting that expulsion is not a sufficient deterrent and random rank allocation exacerbates incentives to default, despite being preferred by participants. Contrariwise, empirical evidence illustrates low strategic default due to high peer monitoring, with a repayment rate of 73.3 percent (Guha & Gupta, 2005). This is partly due to loan sequencing, where allotment is treated as a loan with continual interest, raising monitoring activity amongst members allocated with funds in later periods. Further sustainability, defined as reducing rates of default, is also achieved by excluding defaulting members from a dissolution fund that distributes interest payments.

### Insurance

The risk of spiralling downward into poverty associated with exogenous shocks may necessitate development from informal insurance arrangements. However, the lack of demand for micro-insurance that is normally inferred to exist (Allianz *et al.*, 2006) does not account for the fact that inadequate coping strategies do not necessarily lead to demand for insurance. As Da Costa (2013) evaluates, Allianz *et al.* (2006) unreasonably deduce demand for insurance from the presence of widespread risk, consumption smoothing in lean periods by borrowing, and the increasing supply of insurance.

In fact, most low-income households rely on arrangements within families and communities for insurance rather than market-provided schemes. These are highly effective in certain circumstances, despite not being necessarily as strong as formal systems. Indeed, India has perhaps the most dynamic microinsurance market in the world, but risk still affects the poor disproportionately more than the rich. Rosenzweig and Binswanger (1993) find that an increase in risk in rural South India reduces farm profits by 35 percent for the poorest quarter of households but has no significant effect on the wealthiest.

The importance of caste in collective action extends to informal insurance markets, as the *jati* (sub-caste) network can cover losses in agricultural households (Mobarak & Rosenzweig, 2013). Additionally, Morduch (1999) finds that 75-96 percent of the variation in households remains after removing variables that affect average income across a village. This implies that formalising insurance markets may have negative impacts if they crowd-out successful self-insurance activities such as drawing on savings, selling physical assets, and diversifying into alternative income-generating activities.

## Informal Entrepreneurial Activity

The predominant view held for much of the twentieth century is explained by a structuralist argument, that the informal sector is caused by under-regulation that leads to a lack of social protection in low-paid, insecure, and survival-driven work. Policy was typically framed to create a survival environment, rather than facilitate entrepreneurial growth (Williams & Gurtoo, 2011). However, there has been a recent rise in the neo-liberal view that the size of the informal sector is due to voluntary exit from the formal sector to avoid costs associated with formal registration, high taxes, public sector corruption, or over-regulation. The rise of entrepreneurship has corresponded with emerging literature advocating its importance in economic development through innovation, job creation, and poverty reduction.

The diversity within the informal sector has also been found to feed innovation, which has shifted largely from developed to developing countries. Kraemer-Mbula and Wunsch-Vincent (2016) evaluate informal intellectual property rights where formal institutional costs are too high for most. In many instances, first-mover advantage and community mechanisms are effective alternatives for formal intellectual property laws. The range of characteristics of entrepreneurs (Williams & Nadin, 2010), added to the increased range of incentives documented for joining the informal sector, imply a large range of unrecognised opportunities, particularly as entrepreneurial activity moves from being necessity-driven to opportunity-driven. This shows a preference for informal norms, values, and codes of conduct over formal laws and regulation. There is an argument here for informal sector legitimisation over formalisation, to increase the ease with which opportunities are understood.

## Conclusion

Given this analysis, it seems evident that informal sector activities have the potential to be highly effective in providing alternatives to economic institutional services. Increasing policy effectiveness could, therefore, be achieved by legitimisation and integration of the sector rather than just formalisation, in order to better utilise informal sector institutional strengths.

Informal insurance markets provide clear evidence of preference for informal institutional services, despite deficiencies. This calls for policy to integrate the informal sector, rather than forcing formalisation, which puts this market at danger of failing. In some case, effective policy could also involve the legitimisation of informal services that provide solutions to formal institutional shortfalls into the formal sector. This is seen in collective activity, where social networks can provide resources as far as public goods when institutional cover is inadequate or political institutions are ‘extractive’. Entrepreneurial activity can be argued to most require reform to facilitate the informal entrepreneurial growth, especially as the main drivers of entrepreneurship change.

Extending analysis beyond the three areas of activity discussed here should be the focus of future studies. Further research should also explore policy interventions that can utilise natural informal sector strengths, noting how impacts may vary across communities, castes, religions, and regions. At the very least, there are lessons to be learnt from the workings of the informal sector that can be used to tailor policy effectively. Framing policy appropriately will be significant not just for India, where, as yet, regulation has aimed to weaken informal sector capabilities, but also for several developing countries facing similar conditions.

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**Appendix**

**Table 1: Informal Sector Solutions to Formal Economic Institutional Shortcomings**

| **FORMAL SECTOR** | | **INFORMAL SECTOR** | |
|---|---|---|---|
| **Economic Institutional Provision** | **Problem** | **Activity Category** | **Solution** |
| Welfare system, poverty reduction, employment creation | Lack of inclusive institutional cover | Collective | Familial institutions for capital accumulation, coping with poverty and providing employment opportunities |
| Social security | Lack of inclusive institutional cover | | Social networks and pooled economic resources |
| Public Goods | Free-riding | | Collective self-representation and community-driven development |
| Credit and saving | Behavioural imperfections accompanied by high transaction costs associated with formal banking | Financial | ROSCAs and self-help groups |
| Credit | Credit rationing due to imperfect information and inadequate enforcement mechanisms | | Cultural proximity between lenders and borrowers, peer monitoring and social sanctions |
| Insurance | Low penetration due to moral hazard and adverse selection | | Sub-caste collective insurance and self-insurance |
| Intellectual property rights | High formal institutional costs | Entrepreneurial | Community mechanisms with first-mover advantage |
| Protection to promote innovation | High costs associated with formal registration, high taxes, public sector corruption, or over-regulation | | Social norms alongside high levels of diversity |