

## ECONOMIC FREEDOM - A VECTOR OF TRANSITION FROM THE INFORMAL TO THE FORMAL ECONOMY

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**Abstract:** *This study aims to show that concerted action by the state and civil society can lead to an effective output of informality sphere by official or legal sphere. Such an action is represented by the vector concept named economic freedom. The resultant vector - economic freedom - is obtained by conjugating and composing of noneconomic factors (ownership freedom, freedom from corruption etc.) or cvasieconomic (fiscal freedom, labor freedom, investment freedom, etc.) and it is a prerequisite to a series of actions which are aimed at progressing progress and a healthy economy. If we cannot eradicate the phenomenon of informality, at least we can create a transition from the informal to the formal more efficiently and with positive effects in social and economic policy. The exit from the sphere of informality involves transitions strategies and not a simple translation from one sector to another.*

**Keywords:** informal economics; formal economics; economic freedom; transition strategies

**JEL Classification:** O17; P48; H11

### Introduction

Regardless of the dualistic, structuralist or legalistic visions, the interaction between the formal economy and the informal economy is a challenge for the academic world, governments and national and international institutions. Most often, the transition strategies from the informal to the formal economy either have a descriptive or theoretical character or they are prisoners of institutional bureaucracy. The vulnerability of these strategies is their inability to find a multidimensional method to quantify the translational actions between the two types of economy. The concept of economic freedom (as defined by the Heritage Foundation and by the Wall Street Journal), expressed by 10 qualitative and quantitative factors synthesized in the form of indices, represents in our opinion the instrument through which effective transition strategies can be developed. Given the complexity of the formal-informal relationship and the composite character of the concept of economic freedom, this work falls into the category of conceptual research. In the framework of the methodology used, the deductive aspects are harmoniously combined with the inductive aspects. The conceptual aggregation of the research topic is based on several factors: the informal economy, the formal

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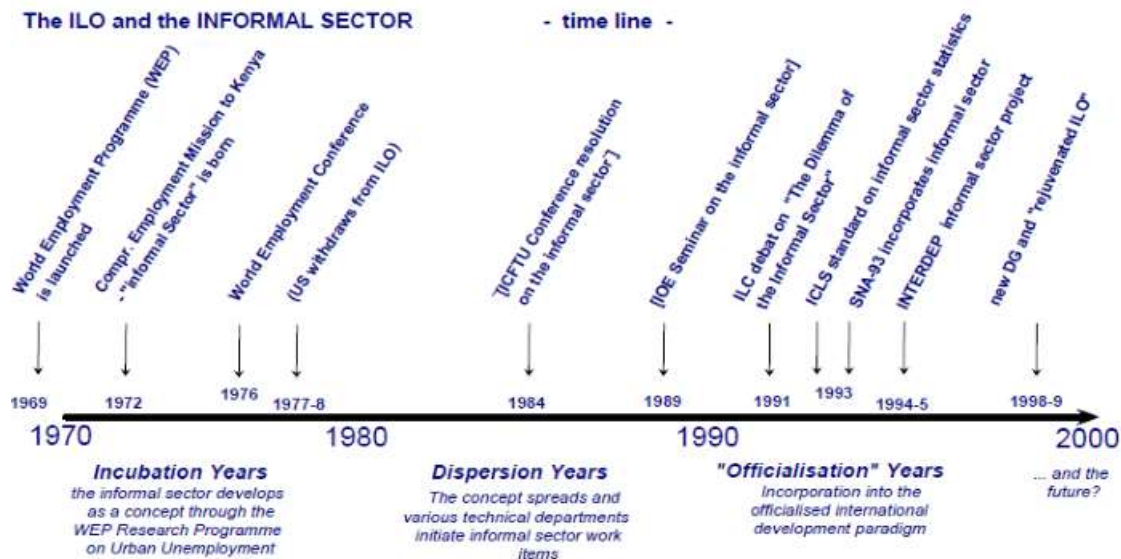
economy, economic freedom - seen globally or in terms of its components, the strategies and the transition actions from the informal to the formal dimension. The first part of the paper intends to define the concept of economic informality and the presentation of transition strategies. The second part of the study is aimed at outlining a model of formal-informal interaction which has as its epicenter the idea of economic freedom that acts as a transition vector from the underground to the official sector.

### **1. Economic informality. The evolution of the concept. Definition**

The concept of informal sector has been launched by the ILO (International Labour Office) five decades ago. Over time, this concept and the social problems that revolved around it have generated heated debates that had as spearhead ILO almost all the time, more than any other international institution.

Economic informalism, or more specifically, the informal sector extracts its sap from the thinking related to the development trends specific to the 50's and 60's; it developed conceptually through 1970; it evolved by being gradually absorbed in the development paradigm of the 1980s and 1990s and the beginning of the 21<sup>st</sup> century. Though the informal sector is still centered on the social justice mandate established by the ILO, the preponderance of the economic side and the complexity of the phenomenon require in our opinion a translation of the analysis of the phenomenon mainly into the fiscal and socio-economic dimensions.

Paul E. Bangasser (2000) proposes an analysis of the concept of informal sector through the "official record" of the ILO, meaning by this the evolution over the time of the concept during conferences, seminars as well as in the papers and documents issued under the aegis of ILO (annex 1). The institutional history of the concept is organized in three phases, correspondent to the three decades presented through timeframe (figure 1).

**Figure 1 -The ILO and the Informal Sector**

Source: Bangasser, 2000, p, 2

Although the term “informal sector” first appeared in 1972, its roots are to be found in the economic development efforts of the 1950s and 1960s, considered years of trust and optimism. The involvement of the UN through its various agencies such as OIM, UNIDO, UNESCO, FAO or OMS has proved to be necessary, especially in terms of achieving a development framework for third world countries. The technical expertise of the OIM targeted the workforce and the workforce planning. As part of the OIM, The Department of Human Resources and Workforce Planning found that some of the aspects regarding the main aspects identified and the workforce recording presented serious shortcomings in the sense that the development plans and some statistical data did not match.

In the first decades of the post-war period, investments and raising labor productivity created numerous jobs. However, less “modern “jobs (in trend with the technological development) were created than what people wanted. Many of the employees found jobs working outside the official or planned “work” frame. Activities of this type were called “informal occupation”, in other words an economic activity outside the official framework. Informal activities took place under various forms: “moonlighting” performed by underpaid clerks, home activities or activities in agriculture.

The phenomenon of urban migration caused in the urban environment a gulf between the “planned employment of labour force” and daily reality. Although a larger number of people were economically active, they were not included in the plans and records of the national and international institutions. The national and international authorities for development and cooperation have reacted quite confusingly as regards to the “fugitives” of the National Development Plans, sometimes manifesting an open hostility, other times showing a benign indifference without being officially encouraged or assisted in doing so. The premise of the workforce analysis was that the problem was

a temporary one and that the development process that was amplified, respectively the “new modern sector” would gradually absorb this escaped workforce. Unfortunately, the “temporary problem” worsened and the gap in relation to the “modern” jobs increased to the extent that it could not be ignored. ILO’s reaction to this paradox consisted in putting in place The World Employment Programme -WEP. The first global mission in the field of employment occupation was held in Africa, the Kenya Mission, in 1972. During this mission the concept of informal sector was implemented.

The 70’s are considered the years of incubation. Although the concept was not embraced enthusiastically by the ILO, some changes were made to meet the challenges posed by the new concept. During the 70’s, a series of events hall-marked the informal sector in the context of the ILO. Among them one can mention the Tripartite World Conference on Employment - Income Distribution and Social Progress and the International Division of Labour (World Employment Conference, June 1976). For the first time, the WEP (1976) brought together the ministries of planning and finance with the ministries of labour at the same table to resolve the problems related to employment.

The 1980s- were the years of dispersion. The activities related to the informal system began to be addressed in other various major programs. The department of labor employment OIM through PIACT (The international programme for the improvement of working conditions and environment, known by its French acronym) included elements regarding the informal work sectors. Also in the 80s, the trend of speculation of the positive vision, idyllic, penciled in during the 70’s over the informal sector takes shape. The concept of “informal sector” has become synonymous with the poorest of the poor, with those who remained behind progress. The perspective on the subjects involved in the informal sector was focused more on “helping the victims” than on analyzing the causes. The vision with pauper accents of the informal sector had as a result the decrease in the expression of the strengths of this sector and made a vision over the informal sector as a viable approach, as originally presented, as an alternative to the formal economy.

The 90’s are recognized as the years of “institutionalization”, by incorporating the concept into the international official paradigm. A series of high profile events regarding the informal sector have marked this decade. Worth noting are two events that had a major impact on the importance of economic informality, namely: the inclusion of the informal sector on the agenda at the 15<sup>th</sup> International Conference of Labour Statisticians (ICLS) and the revision of SNA (System of National Accounts) under the overall leadership of the Statistical Commission of UN, with full technical and financial participation by Eurostat, IMF, World Bank, OECD and various UN specialized agencies.

The year 2002, a representative year for the first decade of the 2000, was a reference year for the ILO for addressing informality. Global recognition and magnitude of the phenomenon marked a

significant movement in the area of conceptual informality by switching from restricted terminology of "informal sector" in the new concept of "informal economy".

In some countries the term "informal economy" refers to the private sector and in other countries, the term is considered synonymous with "underground", "shadow" economy or "gray" (ILC 2002). The ILO unilateral vision over the informal economy is carried on the employment issue. According to the Angelescu *et al.* (2001, p.183) informal economy defies "the totality of undeclared economic activities of institutions in charge of setting taxes and social contributions, which escape from national accounting and statistical records." It can be said that informal economic activities (undeclared) are a starting point for defining informality in the economy. In this respect Neef *et al.* (2007, p.15) conducted an informal classification of activities (table 1) using various criteria analysis tools (illegal-legal, production-transfer, market economy-domestic economy).

**Table 1 - Types of informal activities**

		Market economy		Domestic economy	
		Illegal		Legal	
Production	1a/activities outside the law	Underground economy		Households	
		2a/tax evasion	3a/undeclared work	4a/production of goods and services in the household	
Transfer	1b/corruption	2b/shifts in nature between companies		4b1/ own consumption	4b2/ inter-household transfer

Source: Neef *et al.* 2007, p.15

## 2. Transition strategies

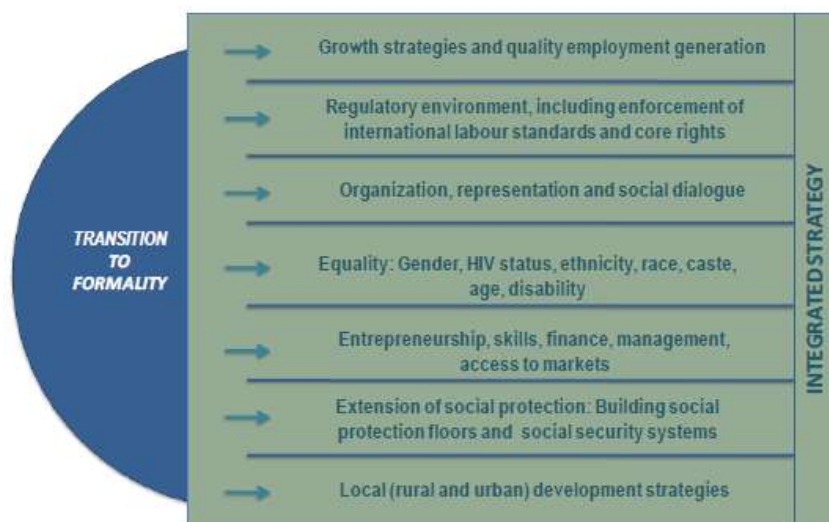
The informal economy was an analysis pretext for researchers, governments and various institutions. The etiology and the morphology related to the study of the informal economy revealed the extent and complexity of this economic phenomenon. Malignant influences at social and economic levels have put on the table the issue of "conversion" of the informal economy (even if not in all, at least in part) by identifying actions and strategies to ensure the transition from the informal area to the formal area.

Chen (2007) analyses the formal-informal relationship by reconsidering the connections between the informal economy and the formal economy through the formal regulatory environment. The author suggests that more "fair" links between the informal economy and the formal economy should be promoted through appropriate policy and regulatory framework. Studies of this kind perceive transition tacitly through the actions of "formalization" of the informal economy. With this understanding, the set of measures and regulations is possible whereby the "actors" of informal

economy can obtain should be promoted licenses, open accounts and pay taxes and customs more easily.

ILO was among the first institutions that saw the need for a coherent way of transition from the informal economy to the formal economy by putting this issue urgently on its agenda (ILO, 2014). The political discussions, debates and analyses have generated a diagnostic framework based on seven main approaches to formalization (figure 2). The diagnostic analysis underlines the importance of vertical integration and advocates for consistency in the entire range of refutable policies of informality, while the horizontal dimension focuses on intensifying the actions in each domain of action policies. The policy areas targeted are: strategies for economic growth and generating employment jobs (quality); regulatory environment including strengthening the international labor standards and fundamental rights, organization and representation and social dialogue; promoting equality gender, race, ethnicity, age, disability; measures - entrepreneurship, skills, finance, management, market access extension of social protection - building a platform of social protection and a system of social security; local development strategies (rural, urban).

**Figure 2 - Transition to Formality – Integrated Strategy**



Source: ILO, 2014, p.13

According to the opinion of Enste (2015) the shift from the informal sphere to the formal sphere can be approached by a two-pillar strategy: 1. Reducing attractiveness, the option called exit options (output from the underground economy); 2. Consolidation voice option (voting and participation). In this model constitutional elements should be consolidated and the instrument-forms of direct

democracy, such as referenda and legislative initiative should be introduced to give citizens more opportunities to participate in the process of decision-making and designing the tax system. Through this strategy a reduction of the attractiveness of the informal economy will be obtained (by diminishing the perception regarding the institution of restrictions as far as the personal liberty is concerned, stimulating fiscal morality, civic consciousness) and a shift towards the official economy.

**Table 2 - A two-pillar strategy for reducing the attractiveness of the existing option (shadow economy) and strengthening the voice option**

<b>Exit option</b>	<b>Voice option</b>
Reducing financial incentives to escape into the shadow economy	Strengthening popular participation in government
Improve and simplify the tax system to strengthen acceptance	Build trust and invest in social capital (for example, through support of corporate social responsibility)
Reform social security systems by strengthening the equivalence principle (more social tax contributions equals higher payments)	Reduce centralization
Boost efficiency in administration and combat corruption	Support more direct democratic elements in some areas
Focus on higher growth and welfare in the official sector to reduce pressure on government budgets	Encourage popular participation to increase commitment and loyalty and reduce free riding
Protect property rights and increase investment in infrastructure	Avoid attacking the symptoms through stricter controls, which encourages hiding participation in the shadow economy rather than reducing it

Source: Enste, 2015, p.9

### **3. Economic freedom vector of transition from the informal to the formal sector**

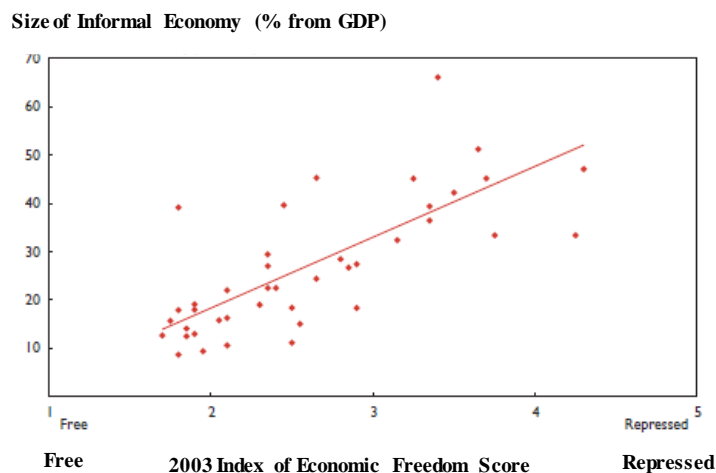
The transition theories developed by researchers or institutions will not prove effective in the absence of a genuine economic freedom. The concept of economic freedom seen in unity or through its components (property rights, freedom of business, financial freedom etc) is in our opinion a serious premise for realizing an effective transfer from the informal area to the formal one. The purpose of this initiative is to achieve a healthy economic and social development.

The Heritage Foundation and the Wall Street Journal have created in 1995 the economic freedom index (annual index) and a ranking based on it to measure the degree of economic freedom of the countries of the world. Economic freedom is defined as the fundamental right of every man to control (elevate) his work and his propriety. In a society free from the economic point of view,

individuals are free to work, produce, consume and invest in any way they want; governments allow labor, capital and goods to move freely; state institutions refrain from coercion or do not exert coercion beyond the extent necessary to protect and maintain liberty itself. Measuring economic freedom is based on 10 qualitative and quantitative factors, grouped into 4 broad categories or pillars of economic freedom: Rule of Law (property rights, freedom from corruption); Limited Government (fiscal freedom, government spending); Regulatory Efficiency (business freedom, labor freedom, monetary freedom); Open Markets (trade freedom, investment freedom, financial freedom)–(The Heritage Foundation, 2015).

Assuming that there is a statistically identifiable relationship between economic freedom and economic development Britton, Ford and Gay (2004) showed that there is a relationship between the economic development and the underground economy. In other words, the more economic freedom there is, the higher the GDP per capita; the higher the GDP per capita is, the lower the participation in the informal economy. The underground economy in Isaac Maniu’s opinion (2004, p. 236) is related to the construction of the economic freedom index that reflects restrictions, taxes and imperfections on the market. Ana Isabel Eiras (2003) considers that the index of economic freedom represents an excellent guide to identify the relationship between informal economic activity and economic freedom. Surveys show a positive correlation between the two factors, the informal economy and the economic freedom index. Figure 3 illustrates the relationship between the economic freedom and the size of the informal economy as a percentage of the GDP in 21 OECD countries and 22 economies in transition. In other words, the more the economic freedom decreases, the higher the share of the informal economy in the GDP.

**Figure 3- Economic Freedom and the Size of the Informal economy**



Source: Eiras, 2003, p. 2



Financial freedom is also expressed by assuring a reasonable access to lending. To have a better standard of living and (implicitly) to escape from poverty, people should have access to credit. In developed countries, for example, without credit, you cannot have a house, a car or a TV, a holiday or more that ensures comfort and convenience in daily life. The loan makes it possible (in the most varied ways) for a middle-class person to make improving the living standard a habit. Proof of income implies a formal job (official) and the property is established through a title. The existence of the informal economy is closely linked to the monetary sphere, in particular by the pronounced inclination towards liquidities (the lack of credit or the possibility of opening an account) that is manifested by those who work as payers or are being paid in this area (Craiu, 2004, p. 90). The motivation of this behaviour is obvious, cash transactions are less visible than banking operations. In a study commissioned by Visa it was pointed out that the underground economy is fuelled by several factors to include the predominance of cash and lack of transparency of transactions (ATKearne *et al.*, 2013).

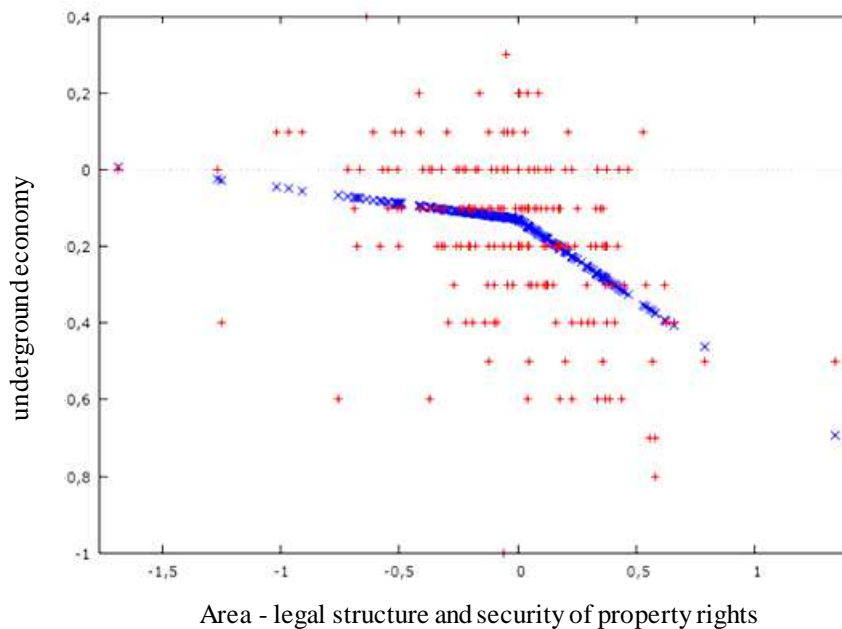
*The institution* of credit, as an output option from informal economy, highlights the fact that people in informal employment are doomed to a standard of living significantly lower than formally employed people (official) and that have access to credit.

We cannot speak of full economic freedom in the absence of full enjoyment of the property rights. Property rights are vital for providing information and signs about the opportunities of buyers and sellers, identifying the proper offers and realizing in safe and accurate conditions the ownership transfer. The relationship between the economic effects of secure property rights and a legal system that works was well explained by Feulner (2002, p. 5). People seen as “economic” actors act primarily in their own interest and tend to carry on with work and investments only if they have a reasonable likelihood of enjoying the fruits of their efforts. In the event that property rights are less secure for example, because of high crime rates or high taxation, people tend to work less and invest less. In other words, the security of private property rights promotes development and facilitates the monetized formal economy. In the situation in which private property rights are weakened, people would have more energy and act with greater dedication in order to avoid formal markets and the integration in the underground economy.

Freytag *et al.* (2013) have shown that economic freedom can be regarded as a global indicator or through two sub-components (1) legal structure and security of property rights and (2) the freedom of international trade that can influence the size and evolution of the underground economy. The greater the economic freedom is, the smaller the size and development of an underground economy. The changes of the freedom index constitute a bench-mark of the involvement or non-involvement in

the underground economy, by the fact that people are more easily willing to leave the underground economy than step into the informal sector. Studies have shown that sub-indices “structure and security of property rights” have by far the greatest impact on the scale and development of the economy. The better the legal system is and the higher the security of the property rights is the smaller the underground economy (comprising the underground economy has as effect an exit from the informality sphere followed by an input in the formal area).

**Figure 4 –The relationship between the changes in the underground economy and changes of economic freedom (area - legal structure and security of property rights)**



Source: Freytag *et al.*, 2013, p. 11

For example (figure 4), when the rate of change of "legal structure and security of property rights" increases with a unit, there is a decrease of 0.19 percentage points in changing the underground economy. In the situation in which the changing rate of the indicator "legal structure and security of property rights" is negative and decreases with a supplementary unit, there will be an increase of 0.014 percentage points in the rate of change of the underground economy.

## Conclusions

Informality creates a culture of contempt for the law, encourages corruption and bribery in the public sector, thus affecting the necessary and beneficial economic freedom. Strengthening the health and legality of an official economy is achieved by implementing through the researchers agenda, government and institutions, the transition from informal to formal. The purpose of this study lies in

the need to achieve integrated transition strategies that can be more easily assessed and measured. The mere reference to the GDP, employment or tax fraud is not sufficient. In our opinion, any transition is doomed to failure if it doesn't consider true economic freedom. Economic, quasieconomic and noneconomic factors that are found in the structure of economic freedom represent reference or action modalities in order to achieve an effective transition to a performant economy. Whether it is the ILO or the national governments, economic freedom should constitute a barometer of official-non official or legal-illegal rapport. In practical terms, based on accurate and well-substantiated scientific criteria can be prerequisites for an assessment of the transition from informal to formal.

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### **Annex 1**

1969 - World Employment Programme (WEP);

1984 – ICFTU (International Confederation of Free Trade Unions) – Conference resolution on the informal sector;

1989 - IOE (International Organisation of Employers) - Seminar on the informal sector;

1991- The dilemma of the informal sector, Report of the Director General, International Labour Conference (ILC), 78th Session;

1993 - International Conference of Labour Statisticians (ICLS) – standard on informal sector statistics;

1993-System of National Accounts (SNA) – incorporates informal sector;

1994 - 1995 Interdepartmental Project on the Informal Sector – INTERDEP - informal sector statistics.