

sustainable markets

The Informal Economy

A primer for development professionals
on the importance of the informal economy
in developing countries

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Could the informal economy be the route to deliver the big sustainable development ideals such as the Green Economy, Millennium Development Goals and Poverty Reduction Strategies, given that its share is rapidly increasing and that the poor mostly operate here? In some developing countries, the share of the informal economy is greater than that of the formal economy. Government planners, donors and NGOs could use the informal or the formal economy to help lift up the wellbeing of the poor and address global challenges such as climate change, but choosing one over the other could lead to most efforts missing the mark. Planning food security, agricultural development, climate adaptation, low-carbon development, and housing requires a careful consideration of the current and future role of the informal economy. In attempting to answer questions about whether or not the informal economy is an impediment to development, whether it should be eliminated or promoted, we realise that the informal economy is not fully understood, is not clearly separated from the formal economy, is difficult to measure and does not necessarily imply illegality. These are among the 10 key messages that this paper raises for development professionals operating in any sector, in developed and developing countries.


First published by International Institute for Environment and Development (UK) in 2011

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Designed by Eileen Higgins eileen@eh-design.co.uk
Printed by Park Communications www.parkcom.co.uk
Cover image © Chris Stowers / Panos

ISBN: 978-1-84369-822-7
Product code: 15515IIED

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The International Institute for Environment and Development is one of the world's top policy research organisations working in the field of sustainable development. With its broad based network of partners, IIED is helping to tackle the biggest issues of our times — from climate change and cities to the pressures on natural resources and the forces shaping global markets.

Introduction

On first hearing the phrase 'informal economy' (IE), most people think of illegal activities, such as trading in drugs or prostitution, paying bribes or avoiding taxes. As such, it is often regarded as something that should be eliminated in pursuit of a formal economy (FE). Without much analysis, one can even assume that the IE is a transitional route to formality as economies grow and regulation becomes stronger.

Yet, reality seems to confound these expectations, at least in the short- to medium-term. The IE currently accounts for over half of global employment and as much as 90 per cent of employment in some of the poorer developing countries. Due to its flexible nature, the IE is in some ways better able to adapt to difficulties such as the current global recession, providing some measure of support to those most in need. Since it provides employment and income for the most impoverished – particularly women – it is a key route to achieving the millennium development goals (MDGs) of eradicating extreme poverty and hunger, promoting gender equality and empowering women. As such, some governments are beginning to become more aware of the vital role the IE plays, especially for the most vulnerable. Because of this awareness, some now look to policies that support the IE to



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become more productive, provide a better voice in governance and a better quality of life for those dependent on it.

Failure to fully grasp the nature, dynamics and drivers of the IE presents a dilemma for the sustainable development agenda. Some of the questions may include: (1) Does development entail eliminating the IE or working with it? (2) Should it be suppressed or promoted, given its predominance? While this paper does not seek to answer these questions directly, it highlights key features and realities of the IE, providing a context for planning and pursuing sustainable development initiatives. Indeed the delivery and outcomes of ideals (such as the MDGs, poverty reduction, climate change adaptation, low carbon development, the green economy, housing for all and agricultural development) depend on the assumptions society makes today about the future economic scenarios which shape rural-urban dynamics, the use of natural resources, and the way in which product and labour markets operate, among other things.

The IE can hardly be measured directly. Even though some individual countries have attempted comprehensive studies, there is little global analysis. The most recent analysis, including World Bank studies, use International Labour Organization (ILO) estimates from 1994 to 2000 and Schneider's estimates for 110 countries over the period 1999 to 2004, to provide a global cross-section of data. A more up-to-date study is clearly needed to illustrate the changes in the size and nature of the IE, particularly in response to the recent recession.

Key messages

1. The global poor and the developing world earn their livelihoods in the informal economy

The informal sector currently accounts for over half the global employment, involving an estimated 1.8 billion people as compared to the 1.2 billion of the formal sector (ILO 2002). In developed countries, the IE predominates as a livelihood activity for poorer people. In developing countries, the IE predominates for all but the richer, urban populations. It is of particular importance for people in poor urban and rural areas, and for women and farmers.

The size of a nation's IE is strongly correlated with levels of economic development (see Figure 1). The average size of the IE as a percentage of the Gross National Income (GNI) is 41 per cent in developing countries, 38 per cent in transition economies and 18 per cent in Organization for Economic Development (OECD) countries, according to average estimates from 1999 to 2004 (Schneider 2002).

Estimates for 110 countries¹

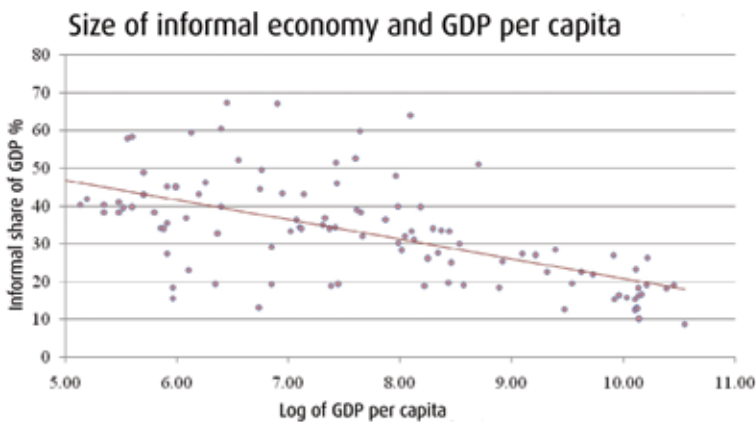


Figure 1

1. Sources: Schneider 2007; World Bank Development Indicators. Informal share of GDP using multiple indicator measures, average of observations available for 1999 to 2004, GDP per capita average for 1999 to 2006.

In the developing world, nation size appears to be an irrelevant factor (Lal and Raj 2006). For example the Small Island Developing States (SIDS) show self-employment (a proxy for informal employment) ranging from 5 per cent of non-agricultural employment in 1990 to 65 per cent in Bahrain to 65 per cent in Haiti (ILO 2002).

2. Globally, the informal economy appears to be growing in both developed and developing countries

The main reason for this growth appears to be that formal labour markets have not been able to generate sufficient jobs to absorb a continuously-growing workforce, particularly for unskilled labour (Flodman Becker 2004). In the 15 countries forming part of EU before the expansion in 1995, the share of IE employment² to total employment increased from 25 to 33 per cent between 1988 and 1998. The corresponding share of IE employment in the US was 25 per cent, where it increased strongly in the 1980s, but did not increase between 1995 and 2001 (ILO 2002).

Developing countries also show high growth in the IE. In 1990 21 per cent of the sub-Saharan African (SSA) labour force of 227 million was working in the IE. However, by 1998 40 to 60 per cent of urban employment was estimated to be in the IE (Charmes 1998 in: Xaba *et al.* 2002). For example, in Kenya, the IE grew at a rate of an estimated 9 per cent a year between 1985 and 1990, and 16.1 per cent between 1991 and 1994. This is 10 times that of the formal sector, which only grew at 1.6 per cent during that period (Xaba *et al.* 2002). In the 1990s, Swaziland's urban IE accounted for 10 per cent of national employment. The IE was growing at an average annual rate of 15 per cent, contrasting sharply with the decline of formal wage employment of 1 per cent annually. By the 1990s, the urban IE was contributing 22 per cent to national employment (*ibid.*).

2. Part time and temporary work and self-employment.

Effects of recession

Growth in the IE appears to have increased during the recession. Estimates show that globally in 2009 there were over 200 million more informal sector workers displaced from formal work, due to rising unemployment. In some cases, the IE can act as a temporary 'cushion' against the recession. For instance in Peru, where the IE is estimated at 60 to 70 per cent, the ILO describes the flexibility between sectors as a primary factor in keeping total unemployment down during the current recession. People took on extra part time or full time work to make ends meet (Slater 2010). Dennis Causso, a street vendor in Peru explains 'I usually work in construction, but when there isn't any work, like right now, I sell candy on the street and to people on the buses' (*ibid.*).

However, many of the sectors having high concentrations of informal workers (particularly women) such as export commodities, export manufacturing, and waste recycling are also the ones that have been badly affected by the current global recession. It would therefore be misleading to suggest that the IE protects workers against the negative consequences of recession. Wages and work conditions decline in the face of increased competition in the informal job market, and those working in the majority of these newly created informal jobs earn less than US\$2 a day.

3. The informal economy is often misunderstood and mis-estimated

There is a common misconception that the IE is the same as the 'black market', so it is treated as something illegal. This misconception undermines both analysis and policy. There is in fact, no single common definition of the IE but the broadest definition covers any economic activity or source of income that is not subject to government regulation, taxation or observation (Schneider 2002). In reality, this means that the IE covers a wide range of activities which are not included in national accounts, such as subsistence farming, small-scale enterprises and illegal activity (Henry and Sills 2006). Informal economic activities are also sometimes referred to as 'underground' activities. Table 1 gives an overview of the different kinds of informal economic activity, ranging from illegal activities, to legal activities with deliberately undeclared sources of income (tax evasion), to legal activities with transactions that have no legal tax obligation (tax avoidance).

Table 1

Taxonomy of types of underground economic activities³

Type of activity	Examples of transactions			
	Monetary transactions		Non-monetary transactions	
Illegal activities	Trade with stolen goods; drug dealing and manufacturing; prostitution; gambling; smuggling and fraud.		Barter of drugs, stolen goods, smuggling, etc. Production or growing of drugs for own use; theft for own use.	
Legal activities	Tax evasion	Tax avoidance	Tax avoidance	Tax evasion
	Unreported income from self-employment; wages, salaries and assets from unreported work related to legal services and goods.	Employee discounts, fringe benefits.	Barter of legal services and goods.	All do-it-yourself work and neighbour help.

The International Labour Organization (ILO) describes the IE as falling into two rough categories (Figure 2): coping strategies (survival activities) and unofficial earning strategies (illegality in business), the latter including both unregistered and criminal activity. While there are many examples of overlap between the two categories, much of the IE remains completely legal and accepted by governments.

Figure 2

Types of informal economy

1. Coping strategies (survival activities)

2. Unofficial earning strategies (illegality in business)

Coping strategies: casual jobs, temporary jobs, unpaid jobs, subsistence agriculture, multiple job holding

A. Unofficial business activities: tax evasion, avoidance of labour regulation, and other government or institutional regulations; no registration of the company

B. Underground activities: crime, corruption

3. Schneider 2002. The structure of the table is taken from Lippert and Walker 1997.

Measuring the IE also presents difficulties. Direct measurement of the IE through survey data is costly and time consuming. Therefore, IE size is usually estimated using macro-level indicators (employment and registers of organisations). Across the IE worldwide, measurement tools and consistent monitoring are lacking. Since both direct and indirect methods are highly imperfect they can only provide an indicator of the 'lower boundaries' of the IE.

Across the informal economy worldwide, measurement tools and consistent monitoring are lacking.

Even in the rare examples where the IE is included in national accounts, for example in Mexico, (ILO 2002) the official estimates do not include the full range of economic activities (*ibid.*). However other methods can be used as corroborative evidence, such as the recent estimate of Mexico's IE using night time imagery as a proxy for total activity and consumption (Ghosh *et al.* 2009). According to the ILO, the IE was as high as 1.55 billion pesos in the year 2000, compared to the official estimate of 1.1 billion pesos from just two years earlier (ILO 2002).

Measuring the IE raises methodological problems as well, as the emphasis is on monetary values such as gross national product (GNP). The result is that the numerous transactions involving work for self and barter exchange are ignored. For instance, the drylands pastoral economy in East Africa features many different trades having a range of timelines and media of exchange – many of them non-monetary – which limits analysis (Hesse and MacGregor 2006). Similarly, the ability to compare any estimated values between the FEs and IEs is unclear, making it difficult to measure and hence compare the same thing.

4. There is no strict separation between the informal economy and formal economy

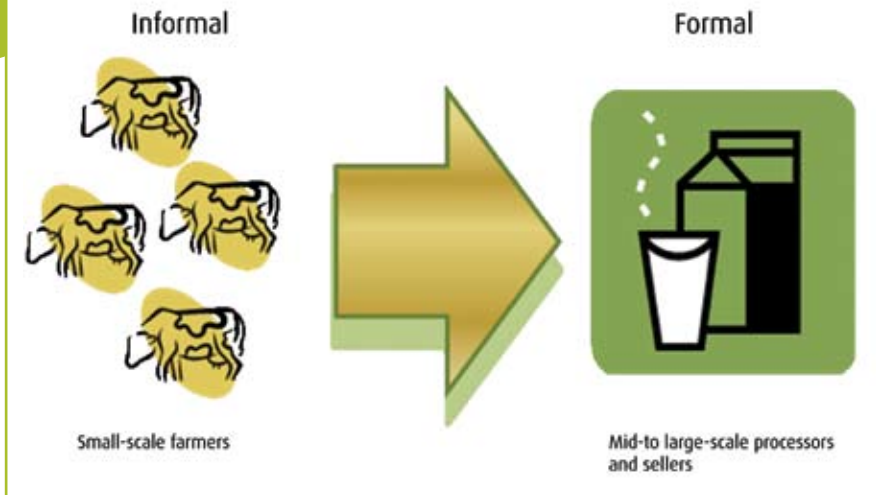
The IE and the FE are part of a continuum with backward linkages involving the flow of raw materials, equipment, finance and consumer goods from formal to informal sector enterprises. There are also limited forward linkages, such as when large domestic companies or government agencies subcontract production to the informal sector or buy their goods directly.

As we see in Figure 3, for instance, inputs to formal businesses in developing countries often move from the informal to the formal sector. Much agricultural produce fits this category. In Kenya, the local supermarkets Uchumi and Nakumatt – both formal market participants – sell fresh produce supplied by local farmers in the informal sector (Battisti *et al.* 2009). Kenyan exports of

leather are produced on the drylands by mobile pastoralists in the IE (Hesse and MacGregor 2006). In Nigeria the informal sector is the source of some 40 per cent of material inputs and 23 per cent of equipment from large companies, respectively, while the formal sector demands less than 10 per cent of its goods from the informal sector.

Figure 3

Kenyan milk production, innovative policy



Business and individuals are not clearly separated into formal and informal, with many working across both sectors. For example, according to the McKinsey quarterly study, Brazil's productivity is compromised by large, registered companies operating partially or wholly outside the law, avoiding taxes, ignoring product quality and safety regulations and/or infringing copyrights. In the 11 key sectors that contribute over 60 per cent to Brazil's gross domestic product (GDP), over half the workers are employed on an informal basis (Capp *et al.* 2005).

5. The scale, size and structure of the informal economy are shaped by several factors

A distinction should be made here between small-scale entrepreneurial or subsistence companies, and those that deliberately avoid their legal obligations. According to Gisele Ferreira-Tiryaki (2008), three key factors have been found to contribute to the deliberate avoidance of participation in the FE:

The overlap between the formal and informal economy challenges our assumptions about how poverty is alleviated.

- ▶ Limited enforcement of legal obligations; for example, in Jakarta, it costs 126 per cent of the debt value to enforce a contract, compared with only 5.4 per cent in Seoul, Korea (IBRD/World Bank, 2003; Friedman *et al.* 2000).
- ▶ The high costs of operating formally, as in Peru, could lead to a situation where full compliance with the country's labour regulations may result in a decrease of over 50 per cent of profit.
- ▶ The transition in Spain to a democratic system changed the extent to which citizens identified themselves with the state and national institutions. This change in social norms had a strong positive effect on people's willingness to join the FE and pay taxes, practically doubling the tax flows into general revenues from 22 per cent of GDP in 1976 to 40 per cent of GDP in 2002 (Ishengoma and Kappel 2006).

Although higher direct taxation has not been found to result in a larger IE, bureaucracy, corruption and burdensome regulation were significant factors (Saavedra-Chanduvi 2007). For example in the Dominican Republic, entry into the FE requires the completion of 21 procedures, costing 80 days and 463 per cent of per capita GDP (Djankov *et al.* 2002). Government attempts to increased formalisation should take into account the practicalities of enforcing additional regulation, so that they can envision whether the proposals are likely to improve efficiency and broaden the tax base, or whether they will inadvertently alienate more companies from the formal sector by making it impossible to survive within it.

6. Macroeconomic growth does not imply informal economy decline

The overlap between the formal and informal economy challenges our assumptions about how poverty is alleviated. Although a larger IE is generally associated with lower GDP per capita, macro-economic growth will not automatically translate into a shrinking of the IE, as long as other underlying causes of poverty, such as poor infrastructure and lack of access to credit, remain unchanged. For example, India has enjoyed a growth rate in GDP of about 6.5 per cent every year over the last decade. While this increase has had some impact on reducing poverty, the IE remains very high at nearly 93 per cent of the workforce, with employment in informal sector of agriculture and small-scale enterprises growing at a faster rate than employment in the less labour-intensive FE sector.



7. The informal economy appears to have several competitive advantages

Since the IE is not bound by the same restrictions as the FE, its participants do not pay taxes or comply with regulations, such as minimum wage, or environmental laws. As a result there are lower barriers to entry and they can, potentially, gain a competitive advantage over formal, registered companies.

These low barriers to entry also allow many people to join the IE as a survival strategy in times of poverty and disaster. Haiti provides a striking example. With its vibrant IE tradition, the flexibility and entrepreneurship possibilities offer a level of resilience to the devastation caused by the earthquake in early 2010. Hundreds of informal businesses have emerged on the streets and camps, with barbers, laundries and food sellers setting up shacks in the midst of the rubble. 'Every person has to find a way to keep his chin up,' said Francaise Etienne a hotdog seller (Miami Herald 2010) while former accountant Sauveur Celestine is now recharging cell phones using discarded car batteries to make ends meet. 'This has enabled me to earn some money that is not a great amount,' says Celestine 'but at least it is enough for me to buy two meals a day' (Scantlan 2010).

Governments and economic planners should be clear to distinguish between legally-allowed small-scale entrepreneurial or subsistence companies and those that either trade in illegal goods or deliberately remain unrecorded to avoid taxation and regulation.

8. Environmental concerns are further cloaked by a close association with the informal economy

Recognising, demonstrating and realising the value of environmental assets – the so-called green infrastructure (IIED 2009) – is a long-term need and part of MDG 7 to ensure environmental sustainability. There are critical poverty/environment linkages associated with economic activity and the use by individuals of many environmental assets. The greatest assets for the poorest are often forests and other environmental services. These supply many rural small-scale enterprises with the raw material assets that they depend on for subsistence livelihoods. Most environmental business sectors in developing countries fall entirely under the IE.

For example, in Namibia, forestry made a direct contribution to the GNP of N\$1 billion,⁴ equal to 3 per cent of GNP. Contributions came from informal economic activity trading and the consumption of thatch, timber and other forest products, such as wildlife, medicine, fruit and honey. Furthermore, it is this area of the IE that will be most vulnerable to environmental degradation and climate change.⁵

9. The informal economy has a weak voice in policy or government

People working in the IE tend to have a lower level of labour organisation as well as poorer access to public infrastructure and benefits. This leaves them highly vulnerable to harassment and abuse. Employers may also take advantage of the absence of formal contracts by not complying with government standards, such as ensuring adequate working conditions and paying the minimum wage. Recently, there have been a number of top-down attempts to improve the welfare and protection of workers in the informal sector. One such example comes from Ghana. Workers in the informal sector, although accounting for 85 per cent of employment nationwide, earn only 40 per cent of national income. The IE here is 'characterised by underemployment, low productivity and substantially low incomes.' In 2010, Ghana inaugurated the National Secretariat of the Informal Economy Project. This aims to enhance the recognition of the IE, acknowledge the role and efforts of women who form the majority of informal labour, build capacity, introduce micro-credit schemes, improve dialogue and flexibility in the labour market, and educate workers in their

4. One Namibian dollar is roughly equal to US\$0.15 cents.

5. Preliminary economic asset and flow accounts for forest resources in Namibia. See Barnes *et al.* 2005.

social and legal rights. Indeed, as in this case, government interest is often heightened only when there is perceived illegality or the potential for formalization. For example, China's recent attempt at increasing formalisation in the waste recycling industry (Waldmann and Stocker 2007).

10. The removal of barriers to a more efficient, stronger informal economy are important development challenges

Many informal enterprises suffer from lack of access to formal credit as well as inadequate market information, infrastructure, government support and a weak legal system. In some cases, the IE companies who lack access to good state-provided institutions, such as social protection against crime,

will be forced to turn to illegal businesses, mafia protection and illegal loan sharks for support. This will result in crime increase, even when the original enterprise is a perfectly legal activity (Straub 2003).

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This can greatly weaken the efficiency of the IE. One vivid example comes from Ethiopia, where most livestock traders have little access to credit and rely on informal price negotiation and contract enforcement. As a result of poor security and legal support, some

20 to 57 per cent of the traders reported that they experienced contract violations of one form or another. Forty per cent of the sample traders suffered from theft of animals, losing an average of US\$157 per cattle trader (Jabbar *et al.* 2008). Creating a supportive environment can help improve the efficiency and positive welfare effects of the IE, as it can through the FE, through training, supportive advice and microcredit schemes.

Conclusion: The way forward

Without necessarily comparing the advantages and disadvantages of the IE with those of the FE, it is evident that the former has increased in share and volume over the past three decades, playing different roles for different players. And while it is not easy to accurately predict the exact share of the IE in the long-term future, the available evidence shows that it is likely to remain significant in the coming two or more decades. It is obviously beneficial to its many legal, and illegal, participants, including the poor and marginalised groups. Specific policy prescriptions are therefore difficult to make.



It is important to distinguish between the different types and causes of an informal sector in order to prescribe the appropriate mix of a) regulation (and taxation), b) protection, both legal and social to the workers and employers, ensuring they have a better voice in governance and are protected from exploitation, and c) promotion which would allow the IE more and better opportunities, including more secure assets (physical, financial and human), better terms of doing business and reduced constraints, in supply-side, demand-side and institutional-side (Chen 2009). The aim should be to take full possible advantage of the positive impact of the IE, while minimising any negative effects that might result from it.

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