

# Informal Economy Literature Review

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## FOREWORD

Some people engage in legal but informal work in the United States in a system of cash-only exchanges. These individuals are operating unregistered businesses or engaging in under-the-table work. This type of economic activity is often called “informal work” or referred to as “the informal economy.” There is a natural link between the informal economy and the services provided by microenterprise programs. Could these informal entrepreneurs be potential new clients? What would it take to move these individuals into licensed small business owners or to grow their after-hours jobs into an income-generating business?

The Institute for Social and Economic Development (ISED) and The Aspen Institute both received funding from the Charles Stewart Mott Foundation to examine the informal economy and its intersection with microenterprise in the United States. ISED and Aspen are conducting ethnographic studies of informal economic activities in three separate urban communities. This qualitative research examines the attitudes and behaviors of informal workers and explores the aspects of working informally that are appealing and may keep people from taking steps to formalize their enterprises.

- ISED is conducting a qualitative study of people in the African-American community who are engaged in informal work. Fifty in-person qualitative interviews will be conducted—25 in Chicago and 25 in Baltimore.
- Aspen Institute is conducting a qualitative study of people in the Latino community engaged in the informal economy in the New York metropolitan area. Forty qualitative interviews will be conducted, including fifteen people who are operating informally and receiving assistance from microenterprise programs. Aspen will also look at the practices of these programs

A first step in the Informal Economy Project is to review the work that has already been done and identify key features of the informal economy. This document represents a joint effort by ISED and The Aspen Institute. A clear message from the review of literature is that informal work activities are a significant presence in the U.S. economy. We discuss some preliminary issues confronting microenterprise programs which plan to offer services to informal economy entrepreneurs.

This first publication from the Informal Economy Project lays the foundation for the in-depth work that will take place in the three cities. Later reports will be released based on the specific findings from the city-specific studies.

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In recent years, about one in four dollars changing hands has not passed through officially accountable channels.

--- American Demographics, (1998)

Fueled by images of street corner vendors, roadside produce markets, and trades people working under the table, the existence of the informal economy is widely known.

-- Jensen, Cornwell, & Findeis, (1995)

Yet, little agreement exists as to what constitutes informal work and this lack of consensus on the proper definition is reflected in the lack of systematic data available to measure it.

-- Tickamyer & Wood, (1998)

## INTRODUCTION

Widespread economic restructuring of the past 20 years—a shift from manufacturing to service sector jobs, an increase in forms of marginal employment, and an increase in small businesses, and a decline in male labor force participation—has changed the way people are connected to the labor market. Scholars began to examine how these changes affected personal employment decisions. At the same time there was heightened interest in the extent to which informal economic activity exists. The informal economy refers to a series of activities that, by occurring outside the arena of the normal, regulated economy, escape official record keeping.

While there are many features of the informal economy discussed in academic literature and technical reports. This paper is not intended to be an exhaustive review of literature. Rather it has a limited purpose, namely, an overview of four major issues—the definition of the informal economy; the various theories or perspectives that attempt to explain the existence of the informal economy; the characteristics of the people who engage in informal work and the industries that are most likely to have a high incidence of informal workers, and the size of the informal economy. Chapters I - IV address these issues. The final two chapters consider the intersection between microenterprise and the informal economy and present important policy implications.

In this literature review, the terms *informal economy*, *informal work*, *informal sector*, and *informal economic activity* are used interchangeably. This review does not cover illegal activities, international research, or people who purchase goods and services in the informal economy. There are entire bodies of research that address each of these issues separately and are beyond the scope of this paper.

Selling oranges in a grocery store is a formal economic activity. Selling them on a highway exit ramp in Los Angeles County to passing motorists is an informal activity.

Likewise, producing T-shirts in a factory where labor and health standards are not enforced is an informal economic activity.

--Marcelli, Pastor, & Joassart (1999)

## **I. DEFINITION OF THE INFORMAL ECONOMY**

In this section, we present the history of the term “informal economy” and the various definitions advocated/promoted by scholars. Two typologies are presented that classify various kinds of work and various kinds of informal economy activities. Four key characteristics of informal work are discussed. Lastly, the work activities that are excluded from the definition of the informal economy are outlined.

### **A. HISTORY OF THE STUDY OF THE INFORMAL ECONOMY**

Various labels have been used by scholars to refer to the "informal economy": it has been called the irregular economy (Ferman & Ferman, 1973), the subterranean economy (Gutmann, 1977), the underground economy (Simon & Witte, 1982; Houston, 1987), the black economy (Dilnot & Morris, 1981), the shadow economy (Frey, Weck, & Pommerehne, 1982; Cassel & Cichy, 1986), and the informal economy (McCrohan & Smith, 1986). The popular media uses terms such as invisible, hidden, submerged, shadow, irregular, non-official, unrecorded, or clandestine (U.S. Department of Labor, 1992). The common thread is that these activities are not recorded or imperfectly reflected in official national accounting systems.

The concept of the “informal sector” was first coined in an International Labour Organization (ILO) study of urban labor markets in Ghana (Hart, 1973). It was subsequently used in ILO reports of labor market conditions in other African cities and by the World Bank in a series of studies of urbanization and poverty throughout the Third World (Sethuraman, 1981; Mazumdar, 1975). In its application to issues of equity, economic opportunity, and social development, the term "informal economy" first came into widespread use as a means of describing a dualistic economic structure found in developing countries. Such an economy involves both the mainstream formal economy and an unofficial economy within which economic transactions occur outside traditional channels and deliver explicit economic and social benefits. The concept has evolved to encompass various types of cash and non-cash transaction in both developing and industrialized economies—transactions that benefit both the poor and non-poor.

Drawing on extensive theoretical and empirical work on Third World countries, researchers began to examine the nature and dynamics of the informal economy in developed countries

(Portes & Sassen-Koob, 1987; Sassen-Koob, 1989; Stepick, 1989). Although similar activities had been observed in European countries (Light, 1979; Feige, 1979), the concept did not gain much initial popularity in the United States. Ferman and Ferman's (1973) paper documented the informal economic exchanges as means of survival among the urban poor of American cities that served as a major breakthrough in the field. Ethnographic studies by Stack (1974), Lowenthal (1975), and Dow (1977) highlighted the informal economic activity within the urban inner city. In 1978, Ferman began reporting the results from his Detroit study that combined anthropological ethnography with survey techniques. This technique later became a standard methodological approach for similar local-area studies (Pahl, 1984).

The literature is marked by considerable disagreement over the conceptual definition of informal work. This dispute was often fueled by different academic disciplines. For example, economists and tax specialists sought to estimate the total size of the informal economy. Their perspective focused on unregulated but cash exchanges (Gutmann, 1977; Feige, 1979; Simon & Witte, 1979; Schoepfle, Perez-Lopez, & Griego, 1992). On the other hand, anthropologists and sociologists often were more broadly concerned with the informal economy's role as a household economic strategy or as a source of community cohesion. This perspective included both cash and non-cash exchanges between and within households (Levitan & Feldman, 1991; Pahl, 1987).

## **B. TYPOLOGIES**

Our understanding of the informal economy may benefit from typologies that classify various kinds of work and that classify various kinds of informal economy activities. We present one of each in this section.

### **1. INFORMAL WORK AS A LABOR MARKET CATEGORY**

The Dual Labor Market Theory (Doeringer & Piore, 1971; Saint-Paul, 1997) provides one approach to understanding the place of informal work within the labor market.<sup>1</sup> It divides the labor market into four categories: primary, secondary, informal, and illegal (see Diagram 1). The authors argue that these categories reflect the class, racial, and gender stratification in our society. The primary sector is regular, wage jobs that are taxed and regulated—for example, heavy industry or white-collar jobs. The secondary sector is composed of jobs that have less security than primary work and are not as well regulated, e.g., lower wage jobs in the service sector (often referred to as “pink collar jobs”). The Dual Labor Market Theory argues that the informal sector is composed of people who are unable to access primary or secondary work. Informal work includes people who operate their own small business in a cash-only or unregulated arrangement or people who work for employers but off-the-books. The fourth category is illegal work and this includes all criminal activity that is revenue generating.

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<sup>1</sup> This categorization has been adopted from the work presented by Cross & Johnson (2000). They argue that these four categories are more two-dimensional with formal vs. informal and legal vs. illegal being more important considerations. See Cross and Johnson's (2000) article for a discussion of illegal activities.

**Diagram 1  
Labor Market Categories**

<b>Primary Sector</b>	<b>Secondary Sector</b>	<b>Informal Sector</b>	<b>Illegal Sector</b>
<ul style="list-style-type: none"> <li>• High wage</li> <li>• High security</li> <li>• Well regulated</li> </ul>	<ul style="list-style-type: none"> <li>• Low wage</li> <li>• Low security</li> <li>• Poorly regulated</li> </ul>	<ul style="list-style-type: none"> <li>• Self-employment</li> <li>• Casual labor</li> <li>• Unregulated</li> </ul>	<ul style="list-style-type: none"> <li>• Criminal</li> <li>• Unregulated</li> </ul>

Source: Cross & Johnson, 2000: 102

One problem with this typology is that it assumes discrete categories based on class, race, or gender. Other research has found that many people who have easy access to the primary sector make the choice to engage in the informal economy, either as their primary source of income or as a means to generate supplemental income.

**2. CONTEXT OF INFORMAL WORK**

Another typology presents categories of informal work based on the context of the work. Given the fairly broad definition of informal work, it is not surprising that there are a variety of forms or structures of informal work.

As depicted in Diagram 2 below, informal work may involve a person working for someone else or a person being self-employed—and within each of these categories there are two arrangements.

**Diagram 2  
Structure of Informal Work Typology**

	<b>Primary work for company</b>	<b>Extra work for current employer</b>
<b>PERSON WORKS FOR SOMEONE ELSE</b>	<ul style="list-style-type: none"> <li>• Works off-the-books</li> <li>• Works under-the-table</li> <li>• Paid in cash and not taxed</li> </ul>	<ul style="list-style-type: none"> <li>• Works extra hours on weekends or evenings (paid in cash and not taxed)</li> </ul>

	<b>Person operates own small business</b>	<b>Does sporadic odd jobs, services, or products</b>
<b>PERSON SELF-EMPLOYED</b>	<ul style="list-style-type: none"> <li>• Cash-only exchanges</li> <li>• On-going, regular</li> <li>• Business is seen as primary income</li> <li>• May invest income into business</li> </ul>	<ul style="list-style-type: none"> <li>• Seasonal work</li> <li>• Helps keep household expenses down by bartering for services or offering low-cost products</li> <li>• Not as formalized as a “small business”</li> </ul>

Source: Adapted from work done by the International Labour Organization, 2002: 12-13.

People who work for someone else may be doing this as their primary job or as extra work, in addition to their primary work, for their primary employer. In one instance the person is employed by a small, medium, or large-scale company, for example, a hotel cleaning contractor that “employs” people off-the-books and pays them in cash. In another instance, this person is

employed by his or her current employer to come in on weekends or evenings, or to take work home to add to his or her income. Again, this arrangement is off-the-books. The people may have approached the employer to increase their income or the employer may have approached the employee. An example of this type of work would be “Sue,” who works in a textile factory and takes garments home to complete additional pieces and earn extra cash.

Other people are self-employed. Under this arrangement people may operate their own businesses, either as a primary source of income or as a way to supplement their income from their primary employment. For example, “Joe” operates a lawn care business as his primary source of income or “Ann” has a household repair business as a means of providing supplemental income in addition to her full-time employment. In a different arrangement the person is still self-employed but may approach his/her work in a less formal manner. For example, “Lisa” makes craft boxes around the holidays and sells them to friends.

### **C. CHARACTERISTICS OF THE INFORMAL ECONOMY**

Since informal work takes so many forms, defining informal work presents many challenges. Perhaps the only way to define it is to identify its characteristics. The following presentation discusses four key characteristics that are widely accepted and includes multiple aspects of some of these characteristics.

#### **1. LEGAL VS. ILLEGAL**

Within the category of informal work, activities may be legal or illegal. Economic activities can be distinguished by the manner in which goods or services are produced or exchanged. For example, food, clothing, and childcare services are legal commodities but may originate in both legally regulated or unregulated production arrangements (Rajjman, 2001). These activities are not intrinsically unlawful but violate some non-criminal rule or law such as not filing taxes or adhering to labor laws (Castells & Portes, 1989; Portes & Sassen-Koob, 1987; Sassen-Koob, 1989; Stepick, 1989).

Income generated by economic activities may be differentiated by the legality of the production or provision of goods and services and the legal status of the goods and services themselves. For example, a hot dog vendor on the street is selling a perfectly legal product—a hot dog that he or she has bought at the supermarket and is offering with value added (prepared, at a convenient location, etc.) to a consumer. It may be, however, that the vendor does not have the proper permits from the health department or evades paying sales tax. The hot dogs are still legal, however. If the police stop the vendor they may seize the goods as evidence and the vendor may be ultimately fined for violating health and tax codes. The situation of a street crack vendor is dramatically different. Even if the crack dealer has any number of legal permits to sell on the street, the product itself is still illegal. While technically both individuals have violated a law, their situations when stopped or arrested are distinctly different. The crack dealer routinely violates the law by the very business he or she is transacting. For the hot dog vendor, the violation occurs only due to failure to follow formal regulations (Cross & Johnson, 2000).

According to the U.S. Department of Labor, legal and illegal are defined as:

- **Legal:** Income is generated from activities that are legal. For a portion of activities that produce legally-sourced income, the appropriate reporting requirement to a taxing or regulatory authority (tax, immigration, licensing) may not be fulfilled. Though underreported, unreported, or concealed, these activities produce goods and services whose sale or exchange is not prohibited. For example, unrecorded and unreported cash payments made for off-the-books or under-the-table work or income from moonlighting (second job) is not reported to tax and social security authorities (1992: 2).
- **Illegal:** Income is generated from activities that are illegal in themselves (e.g., winnings from illegal gambling; earnings from illegal prostitution; smuggling; illegal trade in drugs, tobacco, firearms, and alcohol; skimming of receipts; loan sharking; theft; and other activities specifically banned by law). By its very nature, illegally-sourced income is not recorded in official statistics (1992: 2).

Thus, there is a distinction between informal economic activity that derives its illegality from noncompliance with tax filings and reporting from activity that is criminal, such as that associated with illegal drug distribution, gambling, money laundering, prostitution, trafficking in stolen goods or human beings.

## 2. CASH AS MOST COMMON MEDIUM OF EXCHANGE

Another key aspect of the informal economy is that cash is most commonly exchanged between parties rather than a check, payroll statement, or credit card. The purpose of using currency, rather than bank credit, is to avoid creating a record of the activities (McCrohan, Smith, & Adams, 1991:22-23). The nature of this arrangement is captured in the popular terms of “off-the-books” or “under-the-table” which bring to mind the image of a person receiving payment in a way that is not traceable.

Some transactions in the informal economy may be based on an exchange of services, which is often called bartering or swapping. For example, an auto mechanic may not charge a fee for services provided but may expect a customer who is a dry waller to complete the construction on a room addition. The essential element of this exchange is that there is no official record of this transaction.

## 3. UNREPORTED INCOME OR WAGES

As noted above, the nature of the exchange is cash or bartering so there is no record of the transaction; therefore, the income is not reported for taxation. Both the individuals who work informally and the companies who employ them follow this arrangement. Informal workers are not claiming this income on their state and federal tax forms. Employers who “hire” informal workers are not filing employee records for state and federal taxes.

The issue of taxation is an important consideration. Not all economic activities take place in full view of government officials who can record them, tax them, and regulate them. There are very different perspectives taken by government agencies on informal economic activity (McCrohan, Smith, & Adams, 1991). Both revenue and measurement agencies are interested in

informal work, but there are significant differences between the two agencies. For example, the Internal Revenue Service (IRS) becomes interested in informal earnings when they exceed a certain level. In contrast, National Income and Product Account (NIPA) economists at the Bureau of Economic Analysis (BEA) are concerned with all earnings regardless of the amount.

The subject becomes more complicated when market activity is divided into taxable and nontaxable activity. Taxable means subject to federal income taxation as well as other taxes such as, sales, excise, and state income. The center of the difficulty is that illegal economic activity is omitted by definition from the Gross National Product (GNP), but is taxable. However, legal market activity is part of GNP but may or may not be taxable, depending upon the individual's total earnings. A classification system for viewing this distinction is presented in Diagram 3 (McCrohan, Smith, & Adams, 1991).

Although placing economic activities into one of the four cells depicted in Diagram 3 is somewhat subjective, it can help clarify the different perspectives that can be taken on the informal economy. For example, if an individual employed as a high-school custodian was to finish a neighbor's basement, charging for materials plus \$2,000, and *not* file an income tax return on it, both the IRS and the BEA would be interested in the transaction; but for different reasons. The BEA would simply want to add the money to the national accounts, whereas the IRS would want to collect the taxes due on the money. In this case the payment for the basement would be both taxable and measured (*Cell A*). However if this person were unemployed, and the \$2,000 would not put the informal contractor's income over a certain level, the IRS would have no interest in the money but the BEA would. In this case (*Cell B*), the payment would be measured but not taxable (McCrohan, Smith, & Adams, 1991).

The final two cells (C & D) relate to economic activity that is not measured. Illegal market activity is omitted by definition from GNP, but is taxable and not measured (*Cell C*). Finally, if a family were to have a garage sale and sell a used lawnmower for more than they paid for it, the profit should be reported as income, and taxes paid to the IRS. The BEA, on the other hand, would not be concerned because it is an intra-sector transfer (*Cell D*).

**Diagram 3**  
**Relationship Between Taxable and Measured Market Income**

	TAXABLE	NOT TAXABLE
<b><u>MEASURED</u></b>	Legal Source Market Income: Informal economy  Examples: Payment to a contractor, bartering of vehicle repair for services  <i>Cell A</i>	Legal Source Market Income: Informal economy  Examples: Lawn cutting done by a teenager  <i>Cell B</i>
<b><u>NOT MEASURED</u></b>	Illegal Source Market Income: Illegal sector of informal economy  Examples: Sale of drugs, sale of stolen automobiles  <i>Cell C</i>	Intra-Sector Transfer  Examples: Garage sale, sale of used refrigerator to a neighbor  <i>Cell D</i>

Source: McCrohan, Smith, & Adams, 1991:24

As the preceding points indicate, the informality of the transaction is based upon the factors of legality, the tax situation of the supplier, as well as the necessity of an intersector exchange. Again, although somewhat subjective, such determinations are necessary for income and economic measurements. The house painter who insists on being paid in cash to avoid claiming income and paying taxes does not contribute these dollars to the official GNP. For these reasons, this literature review reports on only legal activities within the informal economy.

#### 4. CONDITIONS OF LABOR

A final characteristic of informal work is the conditions under which workers are employed—labor laws, health conditions, safety hazards, or the location of activities that disregard zoning laws (Castells & Portes, 1989:13). The informal sector is generally seen as being an inferior alternative to formal sector employment in terms of earnings, security, and protection from exploitation regarding labor standards. For example, workers may be offered wages lower than the minimum wage. These wages are also without legally-required benefits such as Social Security, Workers' Compensation, or Unemployment Insurance since there is no official record of employment to file with state and federal authorities. In most informal arrangements, employment standards of age, wage, and hours are typically disregarded. The physical structure in which employees work may also be environmentally harmful and the equipment may be out-of-code and unsafe.

#### D. WHAT IS EXCLUDED FROM THE INFORMAL ECONOMY?

At this point in the paper, identifying what is excluded from the informal economy is essential. It is clear from the preceding discussion that arriving at a definition of informal work is complicated. The literature generally distinguishes criminal activities as being part of the *underground economy*. Although the underground economy is clearly a subset of the informal economy, for the purposes of this study criminal activities are excluded from the definition. As we are using the term in this paper, the *informal economy* includes those enterprises and activities that may not comply with standard business practices, taxation regulations, and/or business reporting requirements but are otherwise *not* engaged in overtly criminal activity.

All goods and services that household members provide for themselves are also excluded from the informal economy. Kacapyr (1998) estimates that by far the largest type of production not included in official accounts is both legal and ethical. Do-it-yourself auto repairs, cooking and cleaning, vegetable gardening, caring for ones own children, caring for elderly family members, and much more fall into this classification—virtually everything people do that could be done by someone else if paid enough. For the purpose of this review, “household services done by household members within their own homes” are not included in this discussion.

Let's face it, the informal economy exists because it is financially advantageous—at least in the short run—for both the employer and the employee. The demand side wants a job done at a discount; the supply side wants the cash.

—Milwaukee Journal Sentinel, 2001.

## II. UNDERSTANDING THE INFORMAL ECONOMY

Economic theorists differ in their views of how the informal economy came into being, what functions it serves, and who participates in it. In this section, several of these major theories and perspectives are presented and discussed. This chapter relies heavily on theories or perspectives found in the literature. Specific research findings related to many of these topics are presented in Chapter III.<sup>2</sup> We begin with a brief overview of the similarities of the informal economies of developing and developed countries. Then we discuss theories of the informal economy as a safety net for the poor versus an additional economic opportunity for those already employed in the formal sector. Third, we discuss theories regarding the connection between the formal and informal sectors. Fourth, we discuss theories that focus on the parallels between the informal economy and low wage labor markets. Finally, we discuss theories that focus on the role of social networks, gender issues, and immigrant issues in the informal economy.

### A. ORIGINS IN INTERNATIONAL THEORIES OF UNDERDEVELOPMENT

The earliest work focusing on the informal economy is from studying the phenomenon in underdeveloped countries. This section describes theories that claim the informal economy is a natural stage in a country's development, an intentional cost-cutting strategy by the part of companies, and the role that regulation plays in economic development.

Economists have traditionally associated informal economic activity with developing countries (De Soto, 1989; Fields, 1975; Marshall, 1987; Sethuraman, 1981) and have emphasized its negative tax implications (Reed, 1985). Less research has been done on the extent, role, and impact of such activities in industrialized countries. This is partly because many analysts have assumed that informal economic activity is a temporary alternative to unemployment and poverty and thus tends to disappear as the economy develops a larger urban industrial base that is capable of absorbing surplus labor (Marcelli, Pastor, & Joassart, 1999).

A number of different views influenced the early work on the informal economy. Advocates of free market strategies assumed that leaving markets to their own devices would result in each actor (including small producers) pursuing the highest economic good. According to De Soto “the choice between working formally and informally is not the inevitable result of people's individual traits but, rather, of their rational evaluation of the relative costs and benefits of

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<sup>2</sup> Summarized research findings are related to: gender, race and ethnicity, level of education, and level of income, regional differences, and occupational differences.

entering existing legal systems” (1989:185). It was anticipated that entrepreneurs operating in the informal economy in developing countries would eventually displace foreign-owned capital and entrepreneurs, setting the stage for these countries to develop full market economies. This has remained elusive for the vast majority of informal actors who are too small, undercapitalized, and insufficiently connected to the formal economy to fulfill this promise. Although many scholars see the informal economy in developing countries as offering only marginal employment opportunities for the urban poor and women—and thus primarily a social safety net—others believed that—with sufficient capital, skills development, and regulatory supports—enterprises operating in the informal economy could grow and help address the high level of unemployment and poverty found in developing countries.

Other theorists view the informal economy as "disguised unemployment" and as an explicit component of the formal economy's arsenal of cost cutting mechanisms. Not only does informal hiring cut labor and fringe costs directly, they further depress industry wage standards (Portes & Walton, 1981). This argument also suggests that unless there are interventions to support indigenous informal enterprises, the sector will never sufficiently accumulate the capital necessary to develop the high-level entrepreneurial capacity to compete with and eventually displace large, foreign-dominated enterprises. Some of the current research attempts to explain the recent resurgence of informal economic activity in industrialized countries, including the United States, and challenges the romanticized idea that most people employed in the informal economy are self-employed, successful, happy microentrepreneurs. As Marcelli et al. point out, most participants in the informal economy "work for private companies under less than favorable conditions," directly enabling firms to cut costs at labor's expense (Marcelli, Pastor, & Joassart, 1999:3). Sassen (1997) links the growth of the informalization in advanced countries to structural changes in the macroeconomy that have exacerbated income inequality and escalated the cost of doing business. The shift from a production-based and manufacturing economy to a service- and information-based economy is characterized by technological improvements that have led to production efficiencies, surplus labor, and the weakening of unions.

Another issue is the relationship between laws and regulations essential to business operation, on the one hand, and the importance of limited regulation to the viability of the informal economy. Information and distribution advances have globalized the factors of production (resources, labor, and capital) while concomitantly concentrating high profit centers in the urban core. This expanded specialized service sector tends to dominate the economic landscape, bidding up the cost of doing business, putting the squeeze on low-margin operations, and demanding a range of lower level services. This expansion of the service sector has exacerbated earning disparities as low wage jobs and alternative hiring arrangements (such as part-time, temporary, contractual labor with no benefits or protections) have proliferated. According to DeSoto, “to make capitalism work for everyone, property rights, laws, and enforcement of contracts must be developed from the bottom up” (1989:73). On the other hand, this school acknowledged that the viability of informal enterprises relies considerably on being able to operate under the regulatory radar screen—that competitive advantage is derived from limited regulations.

## **B. SAFETY NET OR SUPPLEMENTARY EMPLOYMENT OPPORTUNITY**

Another set of theories relates to the purposes the informal economy serves and the roles it plays in developed countries. Some believe it provides a safety net for those excluded from the formal economy, while others argue that it provides supplementary employment for those in the formal sector.

Some theorists believe that the informal economy can be understood by considering fringes of the mainstream economy (Todaro, 1969). The implication is that informal work is done principally by people of low socioeconomic status and serves as a safety net for the poor (Ferman, Henry, & Hoyman, 1987). It is seen as providing the poorest and most marginalized—people who do not have access to the formal sector—with opportunities to earn an income. Proponents of this view tend to argue that, given barriers to participation of women, in particular, in the formal sector, promoting and supporting their involvement in informal sector activities is an important survival strategy for them and their families (Berger & Buvinic, 1989). Other scholars (Duncan, 1992; Gutmann, 1977) argue that formal and informal work are gross substitutes for one another, that is, when people lose jobs in the formal economy, they turn to informal jobs to make ends meet.

On the other side of these issues are theorists who question this correlation between socioeconomic status and informal work (Portes & Sassen-Koob, 1987). They argue that many informal activities require physical and human capital—land, materials, tools, and equipment that the poor tend to lack. For example, to sell fruits or vegetables a person needs access to land and harvesting equipment; to do wood working a person needs a wood shop; and to be a garment working sewing pieces of clothing at home for extra pay a person needs a sewing machine.

Some of these theorists (Pahl & Wallace, 1985) suggest those households that have the resources, ability, wherewithal, and ambition to engage in the formal economy will also be more likely to participate in the informal economy. They argue that this leads to economic polarization, that is, industrious and well-to-do households engage in both formal and informal work, while economically marginal households have little access to either (Pahl & Wallace, 1985). This perspective takes a decidedly negative view of the informal sector, seen as further marginalizing the poorest and most vulnerable people in the society. The proponents of this view argue that efforts should be made to expand employment in the formal sector and that the informal sector should be allowed to disappear (Moser, 1984).

## **C. CONNECTION BETWEEN FORMAL AND INFORMAL SECTORS**

The informal economy consists of both self-employment and wage employment. This section describes the characteristics of both kinds of informal work and how each relates to the formal sector.

For some people, self-employment in the informal sector is the primary source of income. However, more often in the informal economy income from self-employment is combined with regular wage or salary employment, transfer payments such as public benefits, private investments, or savings (Raijman, 2001; Ferman & Berndt, 1981; Hoyman, 1987; Morales, 1997a, 1997b; Tienda & Raijman, 2000; Uzzell, 1980). In other words, informal self-employment is usually part-time employment that provides a supplemental income to people's

primary employment (Alden, 1981). This often involves switching between economic sectors (formal and informal) during the same workday.

For other people, informal work also involves wage employment. In underscoring the danger in defining the informal economy solely as a marginal activity of the poor and excluded, however, Williams and Windebank (1998) point to the considerable number of informal workers earning formal wages as well as the high number of formal workers earning wages comparable to low-wage informal workers. Besides the direct cost savings to firms employing informal workers, additional benefits accrue to people working in the formal economy. For instance, costs saved by using informal workers may be applied to wage increases for higher-level workers employed formally (Marcelli et al., 1999). This is a particularly effective, albeit insidious, job retention strategy in times of tight labor markets.

As can be seen from the above discussion, participation in the informal economy comes from a variety of sources. People may respond to the lack of economic opportunities in the formal economy by creating new activities in the informal economy or by joining existing informal businesses (Raijman, 2001). Informal economic activities serve as an economic buffer while a person is unemployed or they may provide additional income in a low-wage labor market (Hart 1970; Light & Roach, 1996; Morales, 1997b; Staudt, 1999; Stepick, 1989; Tienda & Raijman, 2000). Informal work arrangements may also be a strategy imposed by the process of economic restructuring of big firms, which to minimize costs and maximize flexibility shift their production to subcontractors (Raijman, 2001). Under this arrangement, they push workers out from the formal economy, thus motivating the rise of informal work. As Raijman, (2001:48) notes: "In the context economic restructuring, the informal sector not only provides employment opportunities but also implies a new form of exploitation: individuals are forced to work without the minimal level of protection offered by the legal system, and political mobilization of workers through unions is restricted" (Aponte, 1997; Castells & Portes, 1989; Gowan, 1997).

In Raijman's (2001) article, she succinctly summarized Portes and Sassen-Koob (1987) four of the common linkages between the formal and informal economy. These are:

1. The informal marketing chain. This marketing chain is used by industries to eliminate costs involved in maintaining a permanent sales staff. What appears to be a disorganized mass of street vendors and merchants is actually being well coordinated by a group of middlemen dependent on formal firms (Portes, 1994a, 1994b).
2. The informal supply chain. Informal workers serve as suppliers of inputs to local buyers who, in turn, sell the product to the central wholesaler, the final link to the formal industry (Fortuna & Prates, 1989; Gowan, 1997).
3. Construction and repair services. Formal firms often use informal workers in carrying out construction and repair service contracts. Informal subcontracting allows formal firms to maintain a relatively small regular labor force. Work is assigned to principal contractors who in turn mobilize informal networks (informal subcontractors and laborers) to supply the specific service (Stepick, 1989).
4. Manufacturing. Subcontracting in manufacturing (or sweatshops) relies on individuals who are defined as industrial outworkers and who are under the illusion of self-employment (being nominally self-employed). Actually they work for large firms (Fortuna & Prates, 1989; Portes, 1994b; Sassen-Koob, 1989).

If informal economic activity is a direct outgrowth of the global restructuring that is occurring in the post-industrial economy, it is no surprise that the level of interdependency between the formal and informal sectors is strong and growing. Both consumers and firms drive rising demand for informally produced goods and services.

Economic restructuring has favored specialized services as the primary demand driver. Distinctions have been made between informal economic activities that require higher capital investment and have connections to the formal economy (either through capital transactions, product delivery, or wage setting) and informal economic activities that do not require substantial capital investment and have limited connection to the formal economy. The degree to which informal goods enter formal markets and supply chains and the sufficient infrastructure needed to make these transactions possible further underscores the interrelationship between the formal and informal sectors.

At the individual or household level, success in the informal economy is often predicated on how well one can navigate the nexus between the formal and informal sectors. Ratner (2000) cites a number of examples in which success in the informal economy is a function of having access to goods, services, markets, technologies, etc. in the formal economy and adroitly adapting them for use in informal economic activity. For example, informal opportunities may derive from a household member being formally employed and using the equipment and tools available in that formal employment for informal work outside the hours of employment, e.g., the automobile mechanic who has access to employer's tools and equipment.

Stepick (1989) further distinguishes the isolated and integrated sectors within the informal economy and describes how these two different sectors are connected to the formal sector. Stepick says that the **isolated sector** is that work that remains marginal to the formal economy, e.g., home child-care, home and auto-repair services. The **integrated sector** refers to "those activities in which workers are indirectly connected to a large firm through a chain of intermediaries" (Raijman, 2001:49). These supposedly "self-employed or disguised workers are stripped of the legal benefits of employment while maintained in 'de facto' conditions of dependence" (Cross, 1997:38 as noted in Raijman, 2001:49).

The informal economy cuts across a broad cross section of income and class levels and is represented in most industry classifications. As Gerber (1999:1) notes, the informal economy "has served as a crucial survival strategy for the poor, as a significant provider of jobs to the unemployed, as a training ground for entrepreneurs, as a source of new businesses, and as part of a cost reducing strategy for modern businesses."

#### **D. PARALLELS TO LOW-WAGE, LOW-SKILL LABOR MARKETS**

To some extent the informal economy literature parallels the workforce development literature in discussion of barriers to work for low wage, low skilled job seekers. These workers face considerable obstacles when they are attempting to secure either formal or informal employment. The barriers include:

- Many people lack basic education and language skills, as well as the "soft skills" (such as problem solving and cognitive skills, oral communications skills, personal qualities and work ethic, and interpersonal and teamwork skills) needed for job success.

- Access to occupational skills training that is connected to explicit job opportunities is limited. One of the factors that limit their access is the lack of control over their time, as a result of the erratic schedule of their employment (in low wage work in both formal and informal sectors). Unpredictable schedules often preclude people from pursuing skills training that may help them advance in the formal labor market.
- Jobs are often located outside of the neighborhoods in which low-wage workers live—neighborhoods that are often poorly served by public transportation.
- Access to affordable child care services is limited.
- The hardest-to-employ of these jobseekers also confronts a range of social barriers, including health and learning disabilities, past incarceration, or drug and alcohol problems.

These barriers confront low-wage, low-skilled workers in both the formal and informal economy. Low-wage, low-skilled workers unable to navigate their way in formal labor markets often end up in substandard jobs at wage levels insufficient for supporting a family. For many households and families comprised of low-wage workers in formal jobs, participation in the informal economy becomes a way of cobbling together income and social supports necessary to subsist. Others who are in marginal employment may opt to work only in the informal economy. While the argument can be made that informal employers may be more lenient in accepting the limitations these barriers create—particularly given the strong role social networks play in informal economic activity—the leniency can only be carried so far, because business decision-making tends to follow a certain logic whether the enterprise is formal or not.

Major public policy reforms in welfare and workforce development laid down a particularly challenging gauntlet: to encourage new stakeholders to take an active role in generating employment opportunities for low-wage, low-skilled, hard-to-employ job seekers while modestly reforming the education, training and social services systems. Given the emphasis on livable wage jobs, alliances with unions, performance measures and reporting, and collaborative structures made up of civic, corporate and policy leaders, there was little room to discuss the plausibility of targeting the informal economy as a source of jobs. Furthermore, failure to systematically include formal self-employment in the workforce development strategies further reduced the likelihood that work in the informal economy could provide an entree to the mainstream economy by imparting much needed work experience and job readiness skills. Admittedly, erecting the linkages and technical supports to ensure the transition to formal economy would be arduous, particularly given the systemic difficulties advancing low-wage workers within the formal economy.

## **E. SOCIAL NETWORKS**

Close ties to neighbors, friends and family members often play a role in the existence of informal work activities. This section describes the affect of social networks at both the micro- and macro-level.

Social scientists generally recognize that in tightly knit communities the informal economy allows participants to marshal resources in ways that ultimately keep members from falling below a tacitly understood economic safety net. Gaughan and Femand (1987:16) note that "depending on the type of social milieu, informal economic activities will employ different modalities of exchange, each with different motivations and different expectations of return. These modalities will reflect the nature of the personal ties between participants, defined by norms and institutions that are in essence non-economic." They argue that the informal economy arises partly in response to family or community needs rather than for financial gain. Levitan and Feldman (1991) also found that informal exchanges were quite common in rural households, yet they did not appear to contribute dramatically to economic survival. Rather, these exchange networks were a source of potential economic support in case people fell on hard times and were more apt to exist in areas with stronger social networks.

At the micro level, for example, households may respond to expansions and contractions in the formal economy by adjusting their informal relationships accordingly and expanding reciprocal relationships to weather tougher times. Those households with stronger social networks tend to fair better. In underscoring the importance of social networks and reciprocal exchange relationships to participants in the informal economy in rural areas, Gillespie and colleagues found, "rural households with low and modest incomes that we studied all had access to resources they could use for commercial ends, household provisioning and recreational purposes. None of them can be counted among the more disadvantaged rural poor (Gillespie, Lyson & Harper 1994 as summarized in Ratner, 2000). The extent to which viable social networks are found in urban neighborhoods with concentrated-poverty may have bearing on the level of reciprocal exchanges and other informal economic activity that can be expected.

## **F. GENDER ISSUES**

Some scholars have examined whether men or women are more likely to work in the informal economy. This section describes some of the reasons women are more likely to work informally than men.

Women are more likely to work in the informal sector than the formal sector as the result of their household responsibilities, particularly their responsibilities for the care of children. Those who take a more positive view of the informal sector tend to argue that it is better suited to allowing women to combine household work with paid work because many informal sector activities can be undertaken from the home. Some (Dignard & Havet, 1995; Berger & Buvinic, 1989) argue that women choose informal sector employment because of its compatibility with their household work and thus public policy should support women in this choice by improving their opportunities in the informal sector. Others (Beneria & Roldan, 1987; Moser, 1984) tend to argue that women are forced into the informal sector because the formal sector fails to accommodate their household responsibilities.

Gallaway and Bernasek (2002) argue that the decision whether to participate in the labor market is frequently seen as a decision between two choices: to work or not to work. While this may be the appropriate way to understand that decision for men, there is some question as to how well it explains the labor force participation decisions of women. Paid work is the standard for defining what constitutes work in most economic models, and typically no distinction is drawn between paid work that takes place in the formal sector of the economy and paid work in the informal sector.

According to Gallaway and Bernasek's (2002) even though the work that women do in the home is not considered "work" in the economic sense, it affects their decision whether to participate in the labor market. However, their choices may be more accurately represented as (1) to work in the home without pay or (2) to work for pay in the labor market.

Gallaway and Bernasek's (2002) also found that the presence of infants and toddlers in the household have different affects on the employment choices of men and women. Specifically, they found that infants and toddlers in the home has no effect on men's participation in either formal or informal sector employment, whereas the presence of infants in the household decrease the likelihood that a woman will participate in paid employment in the formal sector and toddlers increase the odds that a woman will participate in informal sector employment.

Furthermore, in developing countries a large percent of economically active women and men work in the informal sector. Women in particular are disproportionately represented in this sector. Often, in these situations, the labor force participation decision may involve the choice between (1) working in the informal sector for pay or (2) working in the formal sector for pay. Given the general perception of the informal sector as an inferior alternative to the formal sector for employment, some scholars have voiced concerns about women being marginalized in this sector (Bernasek, 1999).

Mattera (1985) notes that within the informal economy, the position of men and women is distinct, and to the disadvantage of women. He describes two different sectors in the informal economy in terms of working conditions and financial rewards. The first sector is composed of the "sweatshops, child labor, outwork, and other supposedly anachronistic working arrangements" that have been "appearing with alarming frequency in many of the 'advanced' industrial countries." And the workers that populate this sector "tend to be women, blacks and people of immigrant background." The second sector within the informal economy includes people who toil off-the-book and are often skilled workers earning additional, untaxed income. Mattera states that these workers "tend to be white and male" and are "often in a position to abandon their regular job and establish an underground business." Mattera concludes, "in terms of class structure, the informal economy mirrors the conventional one. There are both capitalists and workers in the underground, and the labor force is segmented into a hierarchy based to a large extent on divisions of sex and race."

## **G. IMMIGRANT ISSUES**

Given that the study of the informal economy began in underdeveloped Third World countries there has been considerable attention given to the presence of informal work in immigrant communities in the United States. In this section, features of immigrant communities and their compatibility with the informal economy are examined.

There are some aspects of immigrant communities that naturally lend themselves to informal employment activities. In her article on informal work by Mexican immigrants in Chicago, Raijman (2001:48) summarized the following points:

“Immigrants are hypothesized to reproduce in the host society forms of economic activity that were common in their countries of origin.<sup>3</sup> These include informal activities, which account for a high proportion of the economies in Third World countries (Aponte, 1997; Castells & Portes, 1989; Hondagneu-Sotelo, 1997; Staudt, 1999). Furthermore, people can be ‘recruited’ into informal self-employment through providing products and services to family, friends, and neighbors in ethnic residential communities” (Ferman & Berndt, 1981).

Immigrants are often vulnerable to the inferior employment arrangements of informal work. Legal and illegal immigrants often provide the labor for sweatshops and irregular enterprises. Illegal immigrants are especially subject to exploitation because of their exposure to explicit or implicit threats of being reported to immigration authorities if they object to working conditions or pay. Legal immigrants face barriers due to language or cultural differences that may limit their employment options and often steer them into the informal economy (U.S. Department of Labor, 1992). The U.S. General Accounting Office found Hispanic and Asian people were the ethnic groups most heavily represented among workers in the restaurant, apparel, and meat processing industries that were operating as sweatshops (1998b).

Portes and Bach (1985) were early claimants that immigrants' employment in enterprises owned and operated by other coethnics (i.e., people of the same ethnic heritage), even at low wages, promoted economic incorporation of recent arrivals. They assumed that socioeconomic integration resulted when workers acquired the knowledge and experience either to establish their own enterprises or to compete more effectively in the open labor market as they mastered English and learned how U.S. labor markets operate. This view presumed that low-wage employment in ethnic firms represents on-the-job training rather than exploitation of recent immigrant workers by coethnics. Informal self-employment may provide an outlet for hobbies not made use of in regular, wage employment. It may also provide a way to develop new skills that may identify new career opportunities (Raijman, 2001; Ferman & Berndt, 1981). Characterized in this manner, ethnic firms operated as training arenas that accord immigrant employees benefits not otherwise available to them in the open market (Bailey & Waldinger, 1991; Zhou, 1992).

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<sup>3</sup> See Sassen's (1997) article, which outlines her position that informalization in post-industrialized Western economies, has not been imported from Third World countries.

“Our faucet was dripping—so my wife made a banana cream pie to give away. If those two events don’t seem connected, you aren’t part of the informal economy that lubricates mountain towns.”  
-- Denver Post, (2001)

“One man interviewed worked as a carpenter for a small cabinet-making company that offered neither vacations nor health insurance, but allowed him to use the company’s equipment in the evening if he had a side job. But he can’t charge any less than \$30 an hour because they [the business] doesn’t want him undercutting them.”  
-- From an interview with a person working in the informal economy. Nelson, (1999)

### III. WHO ENGAGES IN INFORMAL WORK?

Although there is considerable discussion about who is most likely to participate in the informal economy, information on the socio-economic characteristics of workers who participate in the informal economy is relatively sparse.<sup>4</sup> First we discuss why people engage in informal work. Then we present what research has been done regarding gender, race and ethnicity, level of education, and level of income of those in the informal economy. Finally, we discuss regional differences in informal economic activities and the industries that are most likely to have a high incidence of informal workers.

#### A. WHY DO PEOPLE ENGAGE IN INFORMAL WORK?

As can be seen from the previous discussion, people engage in informal work for a variety of reasons. For some it is a necessity, their only resort, or their best option (e.g., it is a better alternative than low-wage formal employment). Others are involved in informal work for personal fulfillment, social obligation, or as a means to supplement primary income.

Lowenthal (1975) refers to the informal economy as being part of a social economy that includes inter- and intra-family labor exchanges. Within the broader community these transactions might include barter and in-kind transfers. The literature suggests informal work may be motivated by social obligation as well as economic gain (Campbell, Spencer, & Amonker, 1993).

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<sup>4</sup> To keep this review of literature manageable, this section is only reporting on the suppliers of informal work, *not* the consumers of informal work. There is an entire line of research dedicated to the people who purchase goods and services through the informal economy (Smith, 1987; Pahl, 1987; Tanzi & Shome, 1993; McCrohan, Smith, & Adams, 1991; McCrohan & Sugrue, 2001; McCrohan & Sugrue, 1998).

For example, Jensen and his colleagues (1995) found that both economic and non-economic reasons were most important for participation (see Table 1). The two reasons of greatest importance were that informal activities were a way to help out neighbors and that they constituted a way to survive. The rank order of reasons was quite similar between poor and non-poor participants. While low-income participants were more likely to be motivated by economic concerns, there was more similarity than difference between poor and non-poor respondents (Jensen, Cornwell, & Findeis, 1995).

**Table 1**  
**Relative Importance of Reasons for Engaging in**  
**Informal Work By Poverty Status**

Reasons	Percent Reporting Reason as Somewhat or Very Important		
	Total	Poor	Non-Poor
To help out neighbors	60.8	64.8	57.8
Because you have to survive	53.7	65.7	44.1
Lets you work at home	43.9	48.1	40.8
Not enough good jobs around	43.5	50.0	38.8
You can set your own hours	40.0	42.6	38.1
You can be your own boss	36.1	33.3	38.1
Because income is not taxed	32.9	33.3	32.7
No transportation worries	21.6	29.6	15.6
Regular job would cut welfare	11.8	21.3	4.8

Source: Jensen, Cornwell, & Findeis, 1995: 99

## B. GENDER

Although the literature on gender and economic restructuring is voluminous (Amott, 1993; Reskin & Padavic, 1994), gender was neglected by those studying the informal economy for many years (Hoyman, 1987; Nelson, 1999). For example, in smaller research studies using non-probability samples, Jensen, Cornwell, and Findeis (1995) did not indicate who in the household was reporting informal economic activities and did not use gender as a predictor variable. Tickamyer and Wood (1998) focused on the household as a whole rather than on individuals within the household. For these reasons, it is difficult to provide an exact picture of the participants. The only three national surveys of informal economic activity in the United States have been conducted to assess the magnitude of consumer use of informal suppliers and not the people who work in the informal economy (McCrohan, Smith, & Adams, 1991; Smith, 1987)

### 1. MEN

The data needed to determine the relative portion of men and women participating in informal economic activity, are generally not available (Hoyman, 1987). One of the few national studies that considered gender suggests that men are more likely than women to be engaged in informal work activities. O'Neill (1983), using data from the U.S. Census Bureau's Current Population Survey (CPS)—in combination with other statistics on employment, unemployment,

and labor force participation rates—found that 27.1 % of adult men are engaged in the informal economy compared with only 13.5 % of women (see Table 2).<sup>5</sup>

**Table 2**  
**Estimated Increase in U.S. Full-Time Informal Employment**

<b>Official Labor Force Status</b>	<b>Number (In thousands)</b>	<b>Percent</b>
Employed		
Wage and salary	1,800	40.6%
Self-employed	700	15.8%
Sub-total	2,500	56.4 %
Unemployed (Black Teens)	41	.9%
Informal Economic Activity		
Adult male	1,200	27.1%
Adult female	600	13.5%
Black teen	90	2.0%
Sub-total	1,890	42.7%
<b>TOTAL</b>	<b>4,431</b>	<b>100%</b>

Source: U.S. Department of Labor, 1992: 17.

## 2. WOMEN

While there is little research to document the participation rates of men in the informal market, more research has been done to answer the question of women's level of engagement, and this work suggests that the presence of women in the informal sector may be larger than that indicated in the O'Neill study. This is due to a number of factors. Most scholars have focused on either women's participation in the labor market in general or "women's unpaid" work in the home. Only recently has research extended this inquiry to consider informal work outside of the home.

This research has linked many female-dominated occupations with informal work status. As Hoyman (1987) argues that many occupational categories are "so sex-segregated that we can assume that nearly all the workers in a specified occupation are female and that all are male, depending on the occupation." When Hoyman's list of female-dominated employment is compared with the list of occupations more likely not to file social security taxes, an interesting conjunction appears. All of the occupations that have a high percentage of nonpayment of social security are female sex-segregated (Table 3).

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<sup>5</sup> O'Neill's approach involved linking similar demographic employment data from different sources in conjunction with assumptions about trends in various determinants of official measures of labor force participation from the CPS to develop an estimate of the increase in full-time employment in the U.S. informal economy over the period of 1950-1981.

**Table 3**  
**Occupation by Nonpayment of Social Security**

Occupation	% Not Paying Social Security
Childcare workers not in private households	84.2
Registered nurses	49.5
Child care workers in private households	48.2
Hairdressers and cosmetologists	24.6
Dressmakers and seamstresses	19.7

Source: U.S., General Accounting Office (1983) as cited in Hoyman, 1987: 68.

Many female-dominated occupations are in the service industry. There is a natural link to high rates of informal work activity in these service occupations. In a U.S. survey of households examining which services were obtained from informal suppliers, “. . . baby-sitting, housecleaning, sewing, laundry, and beauty care were the most often sought-after services by households . . .” (Hoyman, 1987). Though the survey did not specifically ask if the vendors were women, it can be assumed that because these services are traditionally female-occupations, the vendors were women.

Sometimes “women’s work” was not considered in economic terms. Research by Bose, (1987), Jensen (1980) and Smith (1982) has revealed that a range of women’s activities—keeping chickens for egg money and taking in boarders for extra income—do, in fact, fall within the broad definition of informal work but were previously excluded from economic calculations.

Drawing on two complementary sets of interviews with residents of a rural county in Vermont, Nelson (1999) found that participation in the informal economy is extensive and highly differentiated by gender. In Nelson’s interviews with a random sample of rural Vermonters, a second income-producing activity was slightly more common among men than among women (29% versus 19%). However, Nelson makes a critical point by noting that women were often engaged in a variety of activities that did not readily fall within the definition of informal economy used in the study. Nelson supplemented the survey data with in-person interviews and found that women maintained a greater responsibility for housework. In addition, they devoted time (in addition to their regular job or instead of a regular job) to their husband’s businesses—doing the bookkeeping, answering the phones and picking up supplies. Also, women were expected to contribute services, even when those services draw on skills for which they would otherwise be paid. Men’s entrepreneurial activities thus tend to produce cash; whereas women’s activities are more likely to reduce bills. While these practices by women do not earn income, they clearly had economic value for their families (Nelson, 1999).

Although the research that has been conducted on women’s involvement in the informal economy is not conclusive, it does challenge research that states that men are more likely to engage in the informal economy and strongly suggests that women may be as engaged as much as, if not more than, men (Hoyman, 1987).

### C. IMMIGRANTS

Research conducted in New York City and Miami (Portes, Castells, & Benton 1989; Portes & Sassen-Koob 1987; Sassen-Koob 1988, 1989) showed that most workers hired under informal work arrangements, especially sweatshops, were immigrants (Cuban and Puerto Rican immigrants in Miami and South East Asian immigrants in New York City). Similar results were found in other studies (Dangler 1994; Fernandez-Kelly & Garcia 1989; Leonard 1998; Lozano 1989; Pessar, 1994).

Because the informal sector in the United States is perhaps most evident in immigrant communities, there has been a tendency to explain its existence as a consequence of the influx of immigrants and their propensities to replicate survival strategies typical of home countries. This led some scholars to suggest that the rise of an informal economy in the United States is associated with growing immigration. However, there are many examples in the literature in which the informal economy can emerge and grow without large-scale immigration and how the informal economy is present in low-immigrant communities/countries—United States (Portes & Sassen-Koob, 1987), Italy (Sabel, 1982), Great Britain (Pahl & Dennett, 1981), Netherlands (Renooy, 1984) and Spain (Benton, 1986).

Researchers who conduct structural analyses of the causes of informalization note that, “immigrants, insofar as they tend to form communities, may be in a favorable position to seize the opportunities represented by informalization (Sassen-Koob, 1987:60-61). But the opportunities are not necessarily created by immigrants.” Their concentration in defined urban spaces makes them easily accessible resources—cheap and flexible labor supplies—for informal production and distribution of some products and services. In addition, the need for low-cost products and services within these communities and not available from the larger economy (due to actual unavailability, cost, or location) present yet other opportunities for informal work. Gypsy cabs are just one example of many that have emerged in low-income communities in a city like New York (Sassen-Koob, 1987).

Some studies challenge conventional approaches to the economic activities of immigrants and minorities. They observe that, by assuming only one job per worker, these approaches miss the role of informal self-employment in earning a living (Alden, 1981; Gaughan & Ferman, 1987; Morales, 1997a, 1997b; Tienda & Raijman, 2000; Uzzel, 1980 as noted in Raijman, 2001). This consideration is particularly important for immigrant women, who often supplement family income through informal self-employment (Hoyman, 1987; Staudt, 1999). Tienda & Raijman (2000) believe that a great deal can be learned about immigrants' labor market participation by expanding the definition of labor force activity to include multiple-job holding and informal-formal work activities (Raijman, 2001). They argue that informal activities are not captured in most national surveys when conventional labor-force-status items are used and this causes immigrant economic activities to be underreported (Raijman, 2001; Tienda & Raijman, 2000).

### D. LEVEL OF EDUCATION

In urban settings, the association between level of education and participation in the informal economy is clear. Marcelli, Pastor, and Joassart (1999) found a correlation between more education and occupations in which a higher percentage of the jobs are in the formal sector. Thus in occupations in which a high percentage of the jobs are in the informal sector, those jobs

are more likely to be held by persons with less education—and were more likely to pay lower hourly wages. This is consistent with the Gallaway and Bernasek (2002) study, which found that people with the highest levels of education were more likely to be found in the formal sector, whereas those with the lowest levels had the highest probabilities of working in the informal sector.

However, this association between level of education and informal participation did not hold true in rural settings. In Nelson’s (1999) study of participation in the informal economy in a rural setting, a respondent’s level of education (measured as a dichotomous variable less than high school or a high school graduate) had little effect in predicting participation.

**E. LEVEL OF INCOME**

The connection between a person’s level of income and the likelihood that this person will engage in informal work is unclear.<sup>6</sup> Campell, Spencer, and Amonker (1993) reported that when families have access to formal income they are less likely to participate in the informal economy. Similarly, Duncan (1992) found that only those who are left out of even the “bad” jobs—the jobs in fast food industries and the retail sector—are likely to pursue informal work. Others also see informality as a practice of the very poor and of those who by ethnicity or immigration status cannot find a job in the formal labor force (Chu, 1992; Connolly, 1985). However, this interpretation is directly contradicted by research, primarily by British scholars, which found that those in a favored position in the formal economy are most able to develop and sustain informal economic activities (Jensen, Siebel, Ciebel-Rebell, Walther, & Weyrather, 1989; Pahl & Wallace, 1985).

The most recent research shows only slightly higher participation rates in the informal economy for lower-income people. Jensen, Cornwell and Findeis (1995) found that the percentage of families engaging in any informal activity varied somewhat across income categories. Lower income families were more likely to participate in the informal economy—61 % of the second to lowest income group compared with 49 % of the highest income group (see Table 4).

**Table 4  
Engaging in Informal Work and Income Level**

	Annual Family Income				
	\$0-\$7,500	\$7,501-\$15,000	\$15,001-\$20,000	\$20,001-\$40,000	\$40,001 +
Any informal activity	57.5 %	60.7 %	59.4 %	54.1 %	49.2 %

Source: Jensen, Cornwell, & Findeis, 1995: 99

<sup>6</sup> This section presents only findings related to the association between income and informal work. As noted in Section IIIA, there are non-monetary reasons for participation in the informal economy that are not the subject of this section.

Nelson (1999) considered a broader definition of household income and examined how “family status or family income security” in the formal labor market affected participation in the informal economy. Using a random survey of households in one county, the study found that households whose members have held on to “good” work in the formal economy (i.e., a waged job held year-round, full-time that offers benefits) participate in the informal economy in a different way than do households whose members hold “bad jobs” in the formal economy (i.e., part-time, seasonal or temporary jobs). These results are summarized in Table 5.

**Table 5**  
**Informal Economic Activity and Type of Job Held**

	<b>Had a Good Job</b>	<b>Had a Bad Job</b>
Percent of households with at least one adult with a second income activity	35 %	43 %
Percent of household with two adults with a second income activity	12 %	26 %
Percent of all second income activities that are self-employment	61 %	36 %
Percent of men who have a second income activity	25 %	34 %
Percent of men’s second income activities that are self-employment	67 %	40 %
Percent of women who have a second income activity	15 %	26 %
Percent of women’s second income activities that are self-employment	49 %	31 %

Source: Nelson, 1999: 29

Specifically, Nelson found:

- In “good job households,” informal economic activity most often took the form of an entrepreneurial business clearly distinguished from and subordinate to regular work. These individuals spend their days in waged employment and their evenings and weekends on some other paid activity such as: repair services, yard work or landscaping, or making and selling crafts. When the individuals spoke about why they developed on-the-side businesses, they generally did not mention (or at least not at first) the need for additional money in the household. In fact, some people made such enormous investments in their entrepreneurial activities that it would be years before they saw a profit while others turned all profits back into the business. They indicated that they engaged in entrepreneurial activities for three reasons (1) as a safety net to tide them over if they lost their current employment; (2) as an opportunity to hone their craft; or as an opportunity to work with and interact with other people (Nelson, 1999:30-33).

- In “bad job households,” members are generally unable to develop or sustain independent, ongoing entrepreneurial businesses. This was primarily because they usually lacked sufficient capital to invest in the development of an on-the-side business. Some used their employer’s equipment to make items for sale or provide services in the evenings and others took on odd jobs. Still others took additional wage employment. The motivation in the households for informal economic activity was the need for additional income (Nelson, 1999:30-33).

## **F. REGIONAL DIFFERENCES**

While informal economic activity occurs throughout the United States, there are differences in the forms it takes in rural and urban areas. Also, there is evidence that some forms of informal work are concentrated in large urban areas of the country—New York City, Los Angeles, Chicago and Miami. The research related to urban/rural differences is summarized below.

### **1. URBAN**

Sassen (1997) provides many insights into the operation of the informal economy in urban areas. For example, she describes the influence that the highly-capitalized, specialized service sector had on the informal economy. On the one hand, it pulls low-wage informal labor into the metropolitan core to serve the demand for low-end service workers (retail, janitorial, food services, hospitality, etc.). At the same time, this phenomenon drives up business costs, contributes to the dispersal of businesses to outer areas, and forces some operations to seek informal means of redress, such as moving to neighborhoods where costs are lower and zoning and building codes are less restrictive. According to Sassen, these enterprises may be small, medium or large businesses, but they are generally fairly well organized operations.

Typically, the neighborhoods into which the businesses are relocated have experienced disinvestment but were not totally devoid of economic activity. They are, however, often disconnected from regional economic activity. Family-sustaining jobs in the formal sector are limited or held by non-residents, and public and private services are limited. These conditions stimulate another level of informal economic activity: neighborhood-focused small businesses, including microenterprises (employing less than five workers), that are responding to niches left unfilled by the formal economy, namely, the demand for goods and services—generated by consumers and residents—for goods and services otherwise unavailable in disinvested urban neighborhoods.

Highly organized, informal activity is likely to emerge in areas where particular industries make up a substantial portion of the regional economy. Well known examples in New York and Miami are noted in the literature, both of which capitalize on proximity to surplus labor, immigrant populations, and economic forces and costs that enable hidden activity to flourish (Dangler 1994; Fernandez-Kelly & Garcia 1989; Lopez-Garza forthcoming; Leonard, 1998; Lozano 1989; Pessar 1994; Portes, Castells, & Benton 1989; Portes & Sassen-Koob 1987; Sassen 1988, 1989).

- New York City: Abeles, Schwartz, Hackel, and Silverblatt (1983) found that, 90% of interior construction work was done without a permit and by “fly-by-night” businesses. According to the International Ladies Garment Workers Union there were fewer than 200 sweatshops in the New York City in the early 1970s; by 1981 there were roughly 3,000. Expansion of the informal sector was not limited to a few industries but included a diversified consumer services’ sector—gourmet food stores, specialty boutiques, custom-made clothing shops, hand laundries (Sassen-Koob, 1987).
- Miami: The informal economy revolved around the garment and construction trades and customer services in the hotel and restaurant industry. In 1980, the U.S. Department of Labor stated that Miami was swiftly becoming one of the sweatshop capitals of the nation. Home-based work in the garment industry is so prevalent that it was the subject of a special enforcement program by the Wage and Hour Division of the Department of Labor (Stepcik, 1984). Common practices include hiring off-the-books, cash payments, and piecework rates below the legal minimum.

Because informal enterprises essentially behave like enterprises in the formal economy, agglomeration (or clustering) of informal business activity occurs. Industry clusters are "geographically bounded concentrations of similar, related, or complementary businesses with active channels for business transactions, communications, and dialog that share specialized infrastructure, labor markets, and services and face common opportunities and threats" (Rosenfeld, Liston, Kingslow, & Forman, 2000:23). The substantial literature on industry clusters cites their entrepreneurial nature, the important role they play in regional economic growth, and the importance of social networks in undergirding clusters (Rosenfeld, et al., 2000).

While a number of studies of industry clusters have examined industries known to use informal labor, little attention has been given to the issue of informalization in any substantial way. Nonetheless, clusters often include formal and informal enterprises. Sassen (1997:16) provides the example of auto repair "districts" in New York City, where the clustering of formal and informal repair shops has stimulated competition, shared labor market and further entrepreneurial development—clear indications of an activated cluster. The elements of cluster analysis and the implications it has for job creation and workforce development may be a useful framework for examining informal economic activity at the industry level.

The case of New York City demonstrates several key elements important to an understanding of the place of microenterprise within the modern economy (Sassen-Koob, 1987). First, the evolution of the New York City economy over the last thirty years has been based on “a proliferation of small units of production, a trend that contrasts with what was typical in the post-World War II era, when growth was characterized by the vast expansion of the middle class and ever larger scales of production” (Sassen-Koob, 1987:61). Second, the case identifies two markets that have emerged for micro and small businesses, one that is high-priced and directed to high-income consumers interested in non-mass-produced products and personalized services, and the other that is low-priced and directed to serving the needs of the low-income workers engaged in either the formal or informal sectors. The former is represented by high-end wood cabinetmaking that has replaced garment manufacture in Jackson Heights; the latter by low-cost

furniture manufacturing shops catering to low-income communities. Third, the presence of many of these firms in low-income communities demonstrates the economic development potential of microenterprises. Researchers note their contribution to stabilizing these areas by “providing jobs, entrepreneurial opportunities, and enough diversity to maximize the recirculation of money inside the community where the jobs are located and the goods and services produced.”

The case of Miami, on the other hand, demonstrates that the proliferation of microenterprises within an informal economy does not in and of itself lead to positive economic development (Stepcik, 1984). On the one hand, the evolution of Cuban enterprises demonstrates how an “enclave economy” can create a large and prosperous enterprise sector that begins by serving ethnic needs, but grows to integrate with and serve the larger economy. On the other, the evolution of Haitian microenterprise has mimicked that seen in many developing countries—a marginal sector serving strictly ethnic needs and offering severely limited opportunities for real income growth. Interestingly, researchers cite as one strong reason for Cuban success the support and encouragement they received from the government when they arrived in Florida. In contrast, the Haitians have been rejected at almost every turn. The difference in these two cases suggests the importance that government policy and attitude can play in the development of enterprise, both within the informal economy and in its connections to the broader economic community.

## 2. RURAL

Jensen, Cornwell & Findeis (1995) observe that the informal economy is especially important to rural residents in the U.S. for a number of reasons. First, essential services are more likely to be unavailable or deficient in less densely settled areas, forcing people to develop and rely on informal alternatives (Levitan & Feldman, 1991). Second, to the extent that informal activities require access to land, they are more prevalent in rural areas. Third, austerity—in the form of lower wages, declining demand for labor and less public spending—promotes informal economies as an important survival strategy (Miller 1987). Fourth, because informal economies exist in part due to the social interdependence of community members, the “connected feeling” typical of rural places makes them more conducive to informal economic activity (Toennis, 1957).

While limited in number, qualitative studies confirm that informal work features prominently in rural areas. Fitchen (1981) describes the imaginative ways that the rural poor in New York State earned extra money. Junk cars or car parts strewn about a yard are liquidated to make it through a tough month. Friends and relatives offer child care or transportation to those in need in return for cash or other things of value. Studying an economically depressed Appalachian coal-mining region, Duncan (1992:120) described how informal economies evolve in response to deindustrialization: “Those who cannot get the fast-food jobs and other service jobs do ‘odd jobs’ such as babysitting, carpentry, grass cutting, and plumbing jobs. An economy characterized by great inequality generates more ‘odd jobs.’ In this way, the informal sector of a depressed rural economy in the United States is comparable to that in a developing country.”

Campbell, Spencer, & Amonker (1993) examined the informal economy of the Missouri Ozarks by using the case studies gathered by Spense (1992). People worked for payment in-kind, traded goods for the labor of others, rummaged for reusable goods, sold home-produced

food or bartered. These activities allowed residents to adapt in an economy that offered limited formal employment opportunities. However, the authors concluded that these activities were used as a last resort. “The more the formal income, the less the participation in the informal economy—people participated in the use of such tactics by necessity” (Campbell, Spencer, & Amonker, 1993:46).

In their research combining survey data and in-person interviews in rural Pennsylvania, Jensen, Cornwell, and Findeis (1995) found widespread participation in the informal economy. More than half of the sample reported that at least one person in the family engaged in informal work. However, participation was not uniform across types of informal activities. Personal services—babysitting, cleaning, and hairstyling—were the most popular, representing about 30% of all families claiming informal work.

## **G. INDUSTRIES AND OCCUPATIONS**

The adoption of informal activity by businesses varies across industries. While some businesses may purchase production inputs through informal channels, the more common informal economy activity is the use of workers who are paid under-the-table, undocumented workers and other informal labor arrangement. Generally, informal activity shows up in industries where labor laws are poorly regulated or marginally enforced, substantial low wage, low skilled, labor-intensive occupations exist and unionization is minimal to nonexistent. The U.S. General Accounting Office (1998b) found that the restaurant, apparel and meat processing industries had the most serious and widespread problems with multiple labor law violations (i.e., incidence of “sweatshops”).

Industries commonly utilizing informal workers include non-precision manufacturing; electronic assembly; furniture manufacturing; automotive repair; food production and processing; textiles and apparel; hospitality and tourism; and domestic services. Those working in occupations with higher levels of informal economic activity are more likely to be working for private businesses, rather than for the government.

Informal work is also common in the construction industry, especially in painting, carpentry, masonry and laboring trades. While construction is typically identified as a high wage industry, the key to good construction jobs is through registered apprenticeship and ongoing skill development. Day laborers, those working for small contractors, and those working in right-to-work states are less apt to have access to apprenticeship opportunities and are more likely to encounter informal labor practices. Increasingly, a considerable amount of informal employment takes place in information and technology fields (though there are no recent surveys to confirm this).

One way to measure which industries have the heaviest concentrations of informal workers is to survey households and ask them to indicate if they have ever received goods or services that were provided by an informal worker. The percent of U.S. households using informal suppliers for specific services are noted in Table 6. It is important to note that this study looked at individual purchases by households of specific services. Households were not asked to speculate about when they were dining out if their server was a wage employer or if the most recent clothing item they purchased was produced by under-the-table workers. Therefore, these figures do not capture information about the use of informal workers by companies.

**Table 6**  
**Percent of U.S. Households Using Informal Suppliers**  
**by Type of Industry**

Industry	Percent
Food (roadside stand, farmer's markets, etc.)	36.0
Home repair and improvements	17.0
Sidewalk vendor goods	16.0
Flea market goods	13.0
Lawn and garden maintenance	11.6
Cosmetic services (haircuts and beauty services)	11.2
Personal services (child care)	10.8
Domestic services (cleaning, cooking, housekeeping)	9.0
Vehicle repair	7.3
Lessons (educational services)	6.0
Laundry and sewing services	4.0
Appliance repair	1.6
Fuel (firewood)	1.4
Catering	<1.0

Source: McCrohan, Smith, & Adams, 1991: 37.

The most recent data on informal work and occupation was conducted by Marcelli and colleagues' work in Los Angeles (1999). The researchers estimated participation rates by combining data from multiple sources including the U.S. Census Current Population Surveys, a random household survey of the Mexican-born population residing in Los Angeles County, and the Public Use Microdata Sample. The sample included non-Cuban, unauthorized Latino, immigrants. The researchers argue that because of their legal status, such unauthorized immigrants were more likely to work informally and to be subject to different types of regulatory violations than were formal workers. Thus, a measure that captures the degree to which such workers populated an occupation may serve as a proxy for the level of informality. The authors admit that while such a proxy is imperfect, it may at least allow occupations to be ranked and sorted into broad categories of informality (Marcelli et al., 1999: 584).

Although the data were specific to the unauthorized Latino immigrants working informally in Los Angeles, they reveal an interesting hierarchy (see Table 7). The largest concentration of informal employment occurs in occupations that are low paying, require limited skills, and are generally shunned by non-immigrant job seekers—private household services, non-precision machine operators, farm workers, and construction workers. Additionally, this study found that people working in occupations at higher levels of informality tended to work for private companies; had low educational attainment levels; and were more likely to be living in poverty. Self-employed people were represented in far lower numbers, underscoring the exploitative nature of informal work and challenging the popular perception of informal economic activity as "liberating" and "entrepreneurial."

**Table 7**  
**Level of Informality by Occupational Categories**

<b>1. Higher Level of Informality</b>	<b>Percent Informal</b>
Private household services	42.82
Machine operators (not precision)	34.68
Farm workers and related	31.40
Construction laborers	29.64
Cleaning and building	27.50
Fabricators, assemblers, inspectors	26.96
Other handlers, cleaners, laborers	24.98
Food service	24.75
Freight, stock and material handlers	22.88
Forestry and fishing	21.91

<b>2. Intermediate Level of Informality</b>	<b>Percent Informal</b>
Precision production	17.02
Extractive	16.97
Construction trades	15.95
Material-moving equipment operators	14.97
Cashiers	14.89
Motor vehicle operators	13.68
Farm operators and managers	13.30
Mechanics and repairers	12.45
Health service and personal service	11.00

<b>3. Lower Level of Informality</b>	<b>Percent Informal</b>
Other sales	7.77
Other administrative support	6.29
Health technologists and technicians	5.18
Other protective service	5.04
Supervisors and proprietors, sales	3.96
Computer equipment operators	3.76
Financial records processing	3.40
Mail and message distribution	3.36
Sales representatives, finance	3.13
Secretaries, stenographers and typists	3.00
Rail and water transportation	2.87
Officials and administrators, private	2.62
Technologists and technicians (not health)	2.57
Other professional specialty	2.18
Health assessment and treating	1.97
Management related	1.94
Teachers, elementary and secondary	1.91
Other teachers, librarians and counselors	1.90
Officials and administrators, public	1.47
Engineers	0.85
Health diagnosing	0.84
Police and fire fighting	0.71
Architects, mathematicians and scientists	0.70

Source: Marcelli, Pastor, & Joassart, 1999: 586

The business structure of enterprises engaged in informal economic activity in the U.S. includes both large and small operations. This is different from the experience in developing countries, where the informal economy is largely comprised of small- and micro-enterprises that are typically family-operated. Regardless of the size, informally operated enterprises tend to be labor-intensive, operate at low profit margins and have limited access to capital (either private or government). Fixed operating expenses are usually low and inventory is kept to a minimum. They generally do not participate in formal business networks, though their informal networks are strong and yield tangible benefits. Many informal enterprises do not use up-to-date technologies and are less apt to comply with worker safety, environmental, and other regulations. Distribution channels are extremely localized and marketing is generally through word-of-mouth.

Just as businesses in the formal economy must compete on costs versus price, the informal enterprise's best effort at containing costs is to operate outside the regulatory environment. Workers' hours are typically irregular. Wages are usually below industry standards and often below the legal minimum. These types of operations rarely avail themselves of training, workforce development resources, or technical assistance available to businesses. These businesses offer goods and services to customers who are price-sensitive and/or want to avoid regulations or reporting. The trade-off for these customers is that they have limited recourse should the product or service not meet expected standards of quality.

The underground now includes people down the block who sell a variety of goods and services—from firewood to scarves to housecleaning to haircuts to fence posts—all on the condition that payment must be made in cash and is, therefore, difficult for taxing authorities to trace. It also includes the many self-employed people who hide—or fail to report—business income or who engage in barter...

Estimates of the relative size of the underground economy in the United States vary greatly and range upward to 15 and even 25 percent of GNP.

Few doubt that the underground, untaxed and unregulated segment of the economy has been growing in recent decades faster than its aboveground counterpart—possibly giving rise to an understatement in the annual growth rate of the U.S. economy since World War II of at least a quarter of one percent

--(McKenzie & Lee, 1991)

#### IV. SIZE OF THE INFORMAL ECONOMY

Because of its very nature, the informal economy poses tremendous challenges to researchers attempting to estimate its size, and while they have attempted a variety of approaches, the measurement process remains an inexact science. Feige, (1977) for example, declares all forms of measurement flawed in some way. Despite differences in technique, and results, what emerges clearly from the data is the understanding that the informal economy in the United States is surprisingly large.

In this section, four of these approaches and the estimates that they produce are presented. The four principal methods of measurement reviewed are:

- ***Percent of the Gross National Product:*** The dollar value of production occurring outside that counted in the GNP
- ***Percent of Adjusted Gross Income:*** Percent and dollar value of economic activity not reported as part of taxable income
- ***Percent of economically active people:*** The proportion of the population working in the informal economy.
- ***Estimated number of enterprises operating informally at least part time:*** The number of very small enterprises operating across the U.S.

## A. PERCENT OF THE GROSS NATIONAL PRODUCT

Early researchers (Guttman, 1977; Feige, 1979; Tanzi, 1980; 1982) estimated the size of the informal economy by calculating what they believed to be the dollar value of production occurring outside what is counted in the GNP and measured as a *percent of the Gross National Product*. Their estimates varied dramatically, and were based, in simple terms, on calculating the difference between the actual amount of currency in circulation versus the amount expected to be there based on “legitimate” needs of the economy. Gutmann was the first to calculate the size of the informal economy in that way. He estimated that it represented about 10 percent of measured GNP in 1978, or about \$176 billion (Castells & Portes, 1989). In that same year, Feige calculated that the informal economy was equivalent to “more than \$700 billion,” or nearly 27 percent of the GNP (Mattera, 1985). A third researcher estimated it drastically lower, at 4.4 percent of the GNP (Tanzi 1980; 1982). IRS research, based on close examination of some 50,000 taxpayer records and other expenditure analyses, has also come close to that of Gutmann, roughly 8.5% of GNP (Castells & Portes, 1989). Other researchers have suggested that “ten percent [of GNP] is a reasonable working estimate (Mattera, 1985).

## B. PERCENT OF ADJUSTED GROSS INCOME

More recent research suggests that the informal economy may have been erroneously estimated using the percent of GNP measure and proposes, instead, to estimate it as a *percentage of the Adjusted Gross Income (AGI)*. According to Feige (1997: 6), “A common error in presenting estimates of unreported income is to display unreported income as a percentage of GNP. Since GNP includes non-taxable government and private expenditures, the appropriate scale measure for presenting estimates of unreported income is AGI, which forms the basis for assessing taxable income.” Feige then suggests the AGI gap as an unofficial measure of the informal economy, as it serves as a measure of unreported income. He states that in 1992 the AGI gap had risen to \$500 billion and while a portion of this money is “co-circulating” currency being held abroad (“the composite estimate is roughly 40 percent”), that still leaves a rough estimate of \$300 billion circulating within the informal economy in the United States—this estimate does include illegal as well as legal activity (Feige, 1997).

## C. PERCENT OF ECONOMICALLY ACTIVE PEOPLE

Using a third approach, social scientists, especially sociologists, have put more emphasis on the structure of the informal economy, attempting to determine who participates, in which geographic areas, and in which industries. The studies also provide detailed analyses of the types of informal economic activities (Frey, Bruno, Schneider, & Friederich, 2000). This approach results in estimates of the *percent of Economically Active People (EAP)* engaged in informal economic activities in specific components of the economy. Two variants on this approach include:

1. The proportion of individuals in specific occupations not paying social security tax. Hoyman (1987) follows this approach to measuring the informal economy and as reported in the section of this paper on Gender (see Table 3), concludes that large numbers of workers in key industries are working informally on that

basis. The estimates range from close to 20 percent of all dressmakers and seamstresses to over 84 percent of all childcare workers “not in private households,” that operate informal daycare businesses. These numbers are substantial.

2. The percent of the population in specific urban sectors estimated to be working informally. This percent can be calculated using three measures that look at the following:<sup>7</sup>
  - inconsistencies between different sets of data, such as jobs and employment, total and cash transactions
  - identifying individuals in public use data sets based on employment characteristics associated with informality such as self-employment, industries with a high proportion of small scale businesses or unauthorized immigrants
  - conducting ethnographic studies based on direct interviews of informal workers in specific areas and industries (Marcelli, Pastor, & Joassart, 1999).

When applied by researchers in Los Angeles County, between 9 and 29 percent of county employment may be informal. The average of the several measurement approaches applied also led researchers to estimate the size of this labor force at 811,000 workers. “Based on an estimated 811,000 informal workers, and using a conservative estimate of \$7,200 a year in average earnings, the amount of legally required but unpaid payroll tax and insurance benefits for workers in Los Angeles County is over \$1.1 billion per year. The amount of Earned Income Tax Credits that are unavailable to them because of their informal status is estimated to be in the range of \$1.4 billion a year in Los Angeles County” (Marcelli, Pastor, & Flaming, 2002: Summary). While this estimate is only for Los Angeles, the results convey a sense of what might be the magnitude in other urban areas, certainly larger than casual observers would ever anticipate.

#### **D. ESTIMATE OF NUMBER OF ENTERPRISES OPERATING INFORMALLY**

Finally, the last form of measurement is the *estimate of the number of enterprises operating informally at least part of the time*. This measure is perhaps, the most conjectural, based on estimates made by researchers who have observed the behavior of many VSEs (very small establishments). These firms, defined as those with fewer than eight or ten employees<sup>8</sup> represent a significant portion of the U.S. economy. Castells and Portes (1989: 21) note that “about three-fourths of the U.S. establishments counted in the census were VSEs in 1965, and they absorbed approximately one-seventh of the economically active population (EAP). Twenty years later, the figures were almost exactly the same...”

<sup>7</sup> This research is helpful for specific areas and does not necessarily provide generalizable samples for the rest of the country.

<sup>8</sup> The U.S. Census definition changed from one time period to the next, with the larger number of employees, the most current definition.

Castells and Portes use the census count of VSEs as one proxy for the number of firms operating in the informal economy for several reasons:

- their low visibility and ease of displacement provide the most appropriate setting for casual hiring, unreporting of income, and other informal practices
- “direct observational studies indicate that although many small concerns are forced to obtain licenses (and thus appear in the aggregate statistics), their labor practices are mostly informal,”
- their size permits them to convert to totally underground enterprises with ease: “Such a firm can close down ‘officially’ one day and reopen the next as an underground concern” (Castells & Portes, 1989:20-21).

#### **E. U.S. COMPARISON WITH OTHER DEVELOPING COUNTRIES**

For purposes of comparison, it is interesting to note how these estimates compare to those in other parts of the world. One real challenge in making these comparisons is the use of different measurement techniques. Some estimates, however, state that the informal economy in developing countries comprises one half to three-quarters of non-agricultural employment, much larger than the estimated percentage in the U.S. (ILO, 2002). Estimates in other developed countries are considered to be equivalent to or larger than the United States, with estimates of the size of the underground economy relative to the GNP falling between 8 and 30 percent. Japan and Switzerland are estimated to fall at the lower end of this spectrum, while Greece and Italy measure higher towards 30 percent (Frey & Schneider, 2000). Taken together, this data simply demonstrates that the informal economy is a worldwide phenomenon. While the size of this sector in the U.S. may be less than elsewhere, the data nevertheless demonstrates that it is larger than any uniformed observer would expect, and has implications for how policymakers and practitioners should think about issues related to employment, enterprise creation and economic survival.

To paraphrase Granovetter (1985, p. 334), small may not be beautiful, but it is certainly bountiful, and the combined activities of small and unregulated operations now appear to be of more than marginal significance.  
--Portes & Sassen-Koob, 1987

## **V. THE INTERSECTION OF MICROENTERPRISE AND THE INFORMAL ECONOMY**

References throughout this paper have touched on the place and role of microenterprise within the informal economy. This section draws those strands together, summarizing the discussion in the literature, and suggesting some of the issues confronting microenterprise programs seeking to offer services to informal economy entrepreneurs. The natural link between the informal economy and microenterprise, the competitive advantages of informality, and how informal and formal work are often blended, is discussed.

### **A. NATURAL LINK BETWEEN THE INFORMAL ECONOMY AND MICROENTERPRISE**

While the evidence suggests that in the United States the informal economy is more likely to contain wage workers than entrepreneurs, the presence of micro and small enterprises in the sector is substantial and the percentages remain fairly constant. As indicated above, VSEs represent about three-fourths of U.S. establishments counted by census and absorb about one-seventh of the economically active population. VSEs appear to be an enduring feature of the economy. While dominant economic theories have tended to make the assumption that VSEs were transitory, over a twenty year period from 1965 to 1985, their proportional representation in the U.S. economy has remained about the same (Castells & Portes, 1989).

Second, the very nature of being a micro or very small enterprise lends itself to operating in the informal economy. These enterprises are largely invisible or operate at low levels of visibility. They may or may not have licenses, are often engaged in casual hiring, unreporting of income and other informal labor practices. They can be easily moved, opened or closed at will, and thus, can hide from regulation (Castells & Portes, 1989).

Third, the transformations of the economy, as described by Sassen (1989; 1997), suggests at least three areas in which microenterprises can and do thrive in the informal economy in the urban sector:

- responding to the needs of high-income consumers who seek high quality, non-mass produced items and personal services
- serving low-income workers who find the costs of goods and services on the open market prohibitive
- serving commuters and tourists flowing into urban centers on a daily basis through low-cost service operations

Each market niche requires different skills and marketing strategies, and presents different opportunities and constraints in terms of growing an enterprise. The first, for example, can result in high-income gains if the product or service hits the mark in terms of the sensibilities and interests of a sophisticated audience. On the other hand, it can also require taking advantage of low-cost labor to produce at a price the market will bear. The second may offer a broad market, but one that is price constrained, and the third suffers from high levels of competition and low marginal returns. Being successful in any of these is a challenge.

## **B. COMPETITIVE ADVANTAGE**

The competitive advantage that many microenterprises may have in the market place, then, derives in no small measure from their informal nature. Their lower wage rates, non-compliance with tax and social security payments, and inattention to other regulations allows them to operate at cost levels that give them their edge, either in subcontracting relationships to larger firms or in interactions with individual consumers. It is not necessarily obvious to microentrepreneurs that going “formal” will be economically beneficial, which suggests one reason that many microentrepreneurs do not seek out the services of non-profit programs.

However, these competitive advantages can also pose constraints to growth. Microenterprises operating on a cash basis cannot demonstrate the capacity to manage business loans, leaving entrepreneurs either operating with very low levels of capital, or recurring to more expensive and limited sources of financial support (informal sources, personal loans and credit cards, etc.). They cannot accurately value their businesses if they choose to sell them. Neither can they become too visible in their marketing, for fear of becoming apparent to regulators.

## **C. THE CLASHING INTERESTS OF INFORMAL ENTREPRENEURS AND MICROENTERPRISE PROGRAMS**

Microenterprise programs have a strong need to capture data on the effectiveness of their services to clients, and a key way that they seek to do this is through collecting data on business sales and profitability, as well as household income. Their interest in collecting this data can clash with the interest of informal entrepreneurs in keeping it to themselves. For example, the literature documents the blending of informal and formal work by many individuals (see Table 4). This blending may occur not only between a formal job and an informal one, but also within an enterprise itself. Small licensed companies may resort to unauthorized productive arrangements during times of financial crisis (Fernandez-Kelly & Garcia, 1989). There may be a formal presence and reported income, masking informal aspects of its operation—a certain percentage of its sales made “under the table,” wages paid off the books to occasional workers, cash transactions, etc. These realities suggest the real contradiction that exists between a microenterprise program’s interest in reporting profitability and income gains for individuals served, and the individuals’ needs to hide income for tax purposes.

The literature also suggests that the diverse motivations of informal entrepreneurs may make many of them unlikely candidates for microenterprise program services. The sector includes:

- Individuals with “good jobs” who pursue a second self-employment activity less for any immediate economic gain than as a risk management strategy (in case of job loss) or as a creative outlet
- Individuals with “bad jobs,” who lack sufficient capital to fully invest in the development of a business, but who engage in irregular income generating activities or “odd jobs” for immediate economic gain (Nelson, 1999)
- Individuals in rural areas pursuing “odd jobs” in the absence of formal sector opportunities of any type
- Individuals in these same areas engaged in nonmonetized exchange aimed at strengthening their social and economic networks against hard times (Duncan, 1992; Levitan & Feldman, 1991).

Economic development programs seeking to expand their markets need to examine more closely the motivations, capacities, and perceptions of informal workers. It is likely that many of informal workers, especially those who view their entrepreneurial efforts as risk management strategies, would not see themselves as candidates for traditional business plan training courses, or even for loans.<sup>9</sup> Further, many of these individuals view these activities as supplemental and do not envision growing their sideline businesses.

Also the literature reports how many subcontractors operating in the informal sector seek to confuse home-based workers homeowners about their status, suggesting to them that they are high status, self-employed individuals, rather than the contract workers they really are, deprived of worker protections and benefits that they are entitled to by law (Fernandez-Kelly & Garcia, 1989). These different viewpoints represent specific challenges to economic development programs and may influence how they offer potential services.

Operating a business in the informal economy has been identified as presenting opportunities for testing and improving job skills and as a springboard to a more legitimate business, especially for women (Hoyman 1987). In an informal setting, emerging entrepreneurs can test their products and services in a limited market and can gain experience in production, marketing, customer relations, and other business areas without making an investment in registration and other elements of formalization.

But testing skills, even in the informal economy, is not easily accessible to the most disadvantaged. There is some evidence that individuals already in the formal economy have a much better chance of engaging in the informal economy than others (Hoyman, 1987; Pahl, 1984). Individuals with skills learned through work or another formal enterprise bring that experience to their own businesses, whether they operate formally or informally, or both. Research on the relationship between the characteristics of clients who receive services from microenterprise programs and business outcomes finds a similar “incumbency” advantage for those with experience: they are more likely to have a business outcome than those who enter programs with little previous business experience or relevant job skills (Edgcomb, 2002; Losby & Robinson, 2001). Individuals with those skills are often the ones more likely to seek out services. Microenterprise oriented welfare-to-work initiatives, for example, have tended to attract those TANF recipients with higher levels of education and work experience than the general

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<sup>9</sup> Glackin (2002) has developed an analysis framework that lays out all the barriers, costs and constraints that potential borrowers of microloan programs may encounter, and which can be strong deterrents to participation.

caseload (Klein & Kays, 2001: 3). This information suggests that the most inexperienced individuals in the informal sector may be those less likely to succeed in a business and perhaps less likely to seek out services. Microenterprise programs seeking to serve these most marginal of individuals will need to find ways to address their needs for work experience as well as business knowledge.

## VI. POLICY IMPLICATIONS

The wide variety of workers in the informal economy—and the wide variety of researchers looking at them (economists, sociologists, anthropologists)—leads to a broad range of policy recommendations. In sum, these recommendations seek to address how governmental bodies (at the federal, state and city levels), and in some cases community development organizations, can promote the positive aspects associated with the informal economy and repress the negative ones. Related to these are a second set that specifically suggest ways to help individual enterprises transition from informal status to a formal one.

### A. PROMOTING THE POSITIVE ASSOCIATED WITH THE INFORMAL ECONOMY

The amount of attention researchers pay to this question depends upon the extent to which they see the informal economy as a seedbed of dynamic economic growth that can be harnessed and nurtured for the benefit of the workers as well as the larger economy. Some researchers believe, for example, that some “informal economies of growth,” such as those represented by central Italy, Cuban Miami, and Hong Kong, have created real and strong economic impacts for individuals working in them and that their characteristics might be replicated in other settings. While each appears to have unique features that are not easily adapted, the cases do suggest that governments, particularly regional and local governments, have key roles to play in supporting the entrepreneurial spirit in terms of tax policy, simplified regulation and business services: “A positive official posture toward these activities, plus training, credit and marketing support programs, emerge, in every instance, as a sine qua non for their development...” (Portes, Castells, & Benton, 1989”306). This positive posture would include recognizing that very small manufacturing firms are an asset and not a liability to cities, and create tax and other policies to assist them, while at the same time seeking to reduce labor and health code violations (Sassen-Koob, 1989).

Other researchers argue that governments need to factor in the existence of informal workers when estimating the demand for key social services. Hoyman (1987), for example notes that women working informally require day care services for their children, as do mothers counted on the formal work roles, and that government needs to address their needs, and devise services they can access and afford as well.

Finally, other researchers have called for positive tax incentives for micro and small-scale businesses in areas of high poverty and unemployment, and where semiformal neighborhood “subeconomies” (Sassen-Koob, 1989: 74) have emerged. These subeconomies in urban settings are socially desirable responses to situations of high poverty and unemployment, serving “to stabilize low-income communities and generate internal resources that can be recirculated inside these areas... Taking off from the notion of enterprise zones that currently grant tax concessions only to large, formal firms, one could design community zones that would enjoy similar benefits restricted to local entrepreneurs, individual contractors and self-employed workers” (Sassen-Koob, 1989: 75).

## **B. REPRESSING THE NEGATIVE EFFECTS OF INFORMALIZATION**

Researchers have made several recommendations directed to repressing the worst impacts of informal work conditions—sub-minimum wages, no benefits, no health and safety protections, etc. The principal policy recommendation is to apply uniform definitions and monitoring across the broad range of industries in which homework is known to take place, and to enforce the labor code accordingly, maximizing penalties on those who most exploit labor.

Researchers have noted that differentials in the Labor Codes and the ways in which they are enforced have direct impact on the ability of firms to exploit workers. For example, the Federal Labor Code (originating in the Labor Act of 1938) addresses certain industries, such as the garment industry, in detail and leaves others to be included based on judgments regarding their level of injuriousness. The result is that states have considerable leeway. Some industries that have emerged as significant sources of informal employment since 1938—like home-based electronics assembly—have been regulated in some states and not in others. Also, “the application of the ban on homework has as much to do with the differing political strength of industrialists vis-à-vis the state, as with the actual characteristics of home employment.” (Fernandez-Kelly & Garcia, 1989: 252). This is reflected in differential allocation of funds and personnel to monitoring functions that may have nothing to do with the original intent of the law, but more to do with a specific administration’s interest in the “free play of labor supply and demand” than in workers’ rights (Fernandez-Kelly & Garcia, 1989: 254).

Researchers have also observed differences in the definitions applied to what constitutes an employer-employee relationship and to differences in the actions taken by different governmental bodies. A group of researchers found that, at least in California, the IRS appears to have established fairly ample definitions of self-employment and statutory worker, with a concern more for tax liability than worker conditions. The Wage and Hour Division of California’s Department of Industrial Relations, on the other hand, applies a more narrow definition, because their interest is more in worker conditions than taxation. The result, however, has been to allow some unscrupulous employers to confuse workers regarding their actual employment status, as well as to dilute enforcement (Fernandez Kelly & Garcia, 1989). Hoyman (1987: 82), on the other hand, suggests that the IRS has been more helpful than the Department of Labor, which “has endorsed the informal economy to the extent that it has lifted the ban on homework, much to the chagrin of unions, feminist groups and female unionists.”

## **C. MAKING THE TRANSITION FROM INFORMAL TO FORMAL STATUS**

Finally, some researchers have focused on the role that informal small-scale enterprises play in economic development, and suggest that this role can be enhanced if these enterprises move to the formal economy where they can access capital, advertise in the marketplace and link with other mainstream firms. A challenge for policymakers is to find the right way to stimulate positive informal activities and to help move them to the mainstream.

The job creation process in urban United States can be illustrated in the case of a small, informal business. A woman who provides off-the-books day-care services in her home may find it advantageous to report only a fraction of her income. As her business and day-care skills improve, she may recognize advantages from starting a formal, licensed facility with a few employees. Consequently, some or all of her services may shift from the informal to the formal

sector. Development officials could play several roles in encouraging this process, including helping the business owner visualize the growth potential, advising the proprietor regarding various aspects of starting a business, minimizing complicated regulations, and assisting with start-up capital.

Balkin (1989) suggested that movement into the formal economy might be expedited by a graduated regulatory process. He proposed that small businesses that operate partly or completely in the informal sector should be subject to reduced inspection, compliance, and reporting requirements. As businesses expand, they would become subject to stiffer requirements. Thus informal activities could be legitimized without having to meet all the requirements of established businesses. Earlier recognition by public officials could enhance future growth prospects.

Business development professionals may have difficulties identifying promising informal endeavors that constitute all or part of a business activity. Many businesses may be unwilling to deal with governmental agencies because some of their activities may be illegal. Consequently, informal entrepreneurs may best be approached incrementally. Business development specialists have reported that owners of small proprietorships are often reluctant to reveal financial and accounting data (Blair & Endres, 1994). Therefore, small business advisors may wish to emphasize marketing and organizational development services during initial contacts. As the firm grows, activities may move into the mainstream economy to exploit mainstream opportunities.

## CONCLUSION

The breadth of literature reviewed for this document testifies to the significance of the informal economy in the United States. Its size has been measured by economists; its structure and place in the modern economy has been analyzed by sociologists; and the experience of its participants has been described by anthropologists. Together, these disciplines portray a reality that is substantial, pervasive, and a necessary consequence of the imperatives of the larger political economy.

The literature documents two major components in the informal economy. The first is composed largely of those who labor in some form of subcontracting capacity, selling their labor outside the framework of regulation, benefits and any health and safety protections that the formal economy has deemed necessary to fair and positive labor relations. The second is composed of those who work in “side jobs,” “under the table,” “moonlighting,” or full-time in microbusinesses that operate, at least in part, outside the realm of regulation or taxation. While this literature review is more concerned with those who operate in the second category, it is important to recognize that the line between the two is blurry, and there are many who perceive themselves (or are perceived by others) to be self-employed, while they operate in effect as contract workers to others. There are others who work in both capacities as they patch their livelihoods together.

The informal economy has also come to be an “equal opportunity employer.” Among its ranks are men and women, inhabitants of rural and urban communities, documented and undocumented immigrants and native Americans. Within these ranks, the motivations for participation vary, as do the rewards. There are real winners and losers here. Those who manage subcontracting relationships, and those who have technical skills to sell do better than those who have only physical labor to offer. Those, especially women, who work in caregiving occupations and in the household or who offer their work in sweatshop or home-based production work are the most severely disadvantaged. In all cases, the greatest competitive advantage that these workers bring to the market is a price advantage built on lower labor and overhead costs. While this creates access to income and employment for many, it also constrains earning power.

Despite some obvious disadvantages, there are strong reasons why some people remain informal. The informal economy has few barriers to access, and this is especially important to undocumented workers; economic remuneration is attainable; and the avoidance of burdensome regulation is an undeniable boon to small-scale operations. And for many microentrepreneurs, it is not clear whether the benefits of formalization would outweigh the costs involved. As microenterprise practitioners have observed, the desire to grow and a corresponding need for financing, appear the most compelling triggers.

Further, the diversity of self-employed participants in the sector makes policy and practice recommendations difficult. Some policy recommendations are directed to facilitating and supporting the environments in which informal enterprise takes place, especially in very low-income areas and ethnic enclaves. But those that focus on service provision are limited and weak. In the case of microentrepreneurs operating in this sector, there are those who will never seek more than to pursue self-employment on a very limited basis for risk mitigation and income supplementation. There are others who may have larger ambitions, but legal issues constrain

how visible they can become. Still others may have limited skills and capacities, or operate in sectors where price competition is strong. Clearly, more needs to be understood about the goals and ambitions of these groups and others, how they perceive their opportunities and constraints, and what services would they value in light of these. It is probably not too far off the mark to say that most microenterprise programs currently serve those individuals who have already taken (or are willing to consider) steps to formalize their businesses. How they can support those who believe this not to be in their interest is a question that needs more research.

The place to start is with a closer look at microentrepreneurs working in the informal economy. Future documents under this project will report on the results of interviews with representatives in three major metropolitan areas, as well as take a closer look at how program practices that support or inhibit service delivery to these microentrepreneurs. It is hoped that this work will provoke greater recognition of this substantial, yet hidden, component of the “microenterprise market,” and lead to strategies that can more effectively help people move from marginality to economic self-sufficiency, using self-employment as a tool.

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