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# Making Sense of Informal Economies in Fragile Contexts

## Issues, Dilemmas and Questions

Increased attention for job creation, private sector development and illicit financial flows in fragile contexts has rekindled policy interest in the phenomenon of economic informality. Yet, conventional responses to informal economies may not be suitable for fragile situations due to the particular challenges posed by the dynamics of fragility and conflict. International development actors therefore need to recalibrate intervention strategies geared toward addressing economic informality in fragile contexts. This also requires them to look beyond the economic dimension of informal economies and pay attention to the political and social undercurrents that sustain patterns of economic informality in fragile environments. Development actors are also confronted with a number of dilemmas about the appropriate level of engagement with the informal economy, the envisaged role for the state, the development potential of informal economies, and hybrid forms of economic governance. Finally, important questions about the manner in which informal economies shape governance, development and conflict patterns in fragile environments remain to be addressed.

### Introduction<sup>1</sup>

The informal economy remains a topic of interest for academics, policy-makers and development practitioners, although its prominence in development discourse has waxed and waned during the last four decades. Now, it seems, this phenomenon is once again attracting the attention of international development actors.

An increased focus on private sector development and job creation, now touted as important stepping stones for transition out of fragility, is gradually pushing the informal economy to the centre of policy conversations. International support strategies inevitably have to take into consideration informal economies that provide local communities, in particular vulnerable and marginalised groups, with livelihoods, incomes and jobs.

<sup>1</sup> This policy brief benefited from an expert seminar on the topic of informal economies in fragile contexts, which took place 20 and 21 January 2015. Comments on earlier drafts from seminar participants and colleagues at the Conflict Research Unit (CRU) are gratefully acknowledged. A policy-mapping exercise conducted by Paul Lange, project assistant at the CRU, proved very helpful. The contents of this policy brief are the responsibility of the author.

Attention to the informal economy has also been rekindled as a result of the broad consensus now existing that development formulas for fragile contexts should factor in informal institutions and non-state actors. The notion that informality matters moreover coincides with a growing preoccupation among Western donors with all things illicit – whether illicit flows, goods

or networks – and their effects within and beyond the borders of fragile states.

Finally, growing acceptance of the remarkably resilient nature of the informal economy provides further impetus behind the interest in this phenomenon. Expectations that informal economies across the globe would eventually wither away in the face of development progress have been confounded. On the contrary, globalisation and partial deregulation of the world economy appear to have generated the conditions in which informal economies can thrive and even expand.<sup>2</sup>

Against the backdrop of renewed attention given to the informal economy, this policy brief explores its relevance for international development and peace-building efforts in fragile contexts. In addition to identifying some of the issues that stymie effective policy engagement with the phenomenon of economic informality, the brief emphasises the need for a recalibrated approach towards informal economies that are situated in fragile contexts. Furthermore, the brief draws attention to four policy dilemmas that deserve further consideration from international development actors, before concluding with an overview of thematic areas that should be the subject of further research.

## Pinning down an elusive concept

Informal economies encompass a broad range of economic activities. Motorcycle taxis, street vending and waste collection represent obvious examples of informal livelihood activities. At a more systemic level, there are trading networks that operate across borders, artisanal mining activities that exist alongside large-scale mining operations, wholesale markets for pirated commodities such as CDs and DVDs, clusters of informal manufacturing

enterprises that form part of global supply chains, and community-based systems for saving and credit provision.

The diverse nature of economic informality is also reflected in the settings in which this phenomenon unfolds itself: sprawling megacities such as Karachi, Lagos and Mexico City, the desert area of the Sahara–Sahel region, border towns such as Ciudad del Este in Paraguay, the internal economy of refugee camps, or the borderlands of countries where the reach of the central state is limited.

Considering these examples, it should come as no surprise that defining and comprehending the concept ‘informal economy’ has proved to be remarkably difficult. One phenomenon that illustrates this difficulty is the sheer number of adjectives that are regularly attached to the concept: hidden, parallel, clandestine, grey, underground, shadow, illicit, unregulated, subsistence, coping, non-monetised, alternative, illegal and so on.

Clearly, the heterogeneous nature of informal economies calls for a definition that is “as nuanced and flexible as the informal economy has proven to be”.<sup>3</sup> Taking its cue from the consensus<sup>4</sup> that has gradually emerged in the academic domain, this policy brief defines the informal economy as encompassing all economic activities that do not adhere to the state’s institutional rules or are denied their protection.<sup>5</sup> Central to this definition is the state’s prerogative to demarcate a formal sphere of economic production and exchange, and conversely, to regulate or criminalise economic activities.<sup>6</sup>

2 Castells, M. and Portes, A. ‘World underneath: The origins, dynamics, and effects of the informal economy’, in: *The Informal Economy: Studies in Advanced and Less Developed Countries*, ed. Portes, A. et al. Baltimore: Johns Hopkins University Press.

3 Portes, A., *Economic Sociology: A Systematic Inquiry*. Princeton: Princeton University Press, 2010, 161.

4 Portes, A. and Haller, W. ‘The informal economy’, in: *The Handbook of Economic Sociology*, ed. Smelser, N. and Swedberg, R. Princeton: Princeton University Press, 2005, 404.

5 Feige, E.L., ‘Defining and Estimating Underground and Informal Economies: The New Institutional Economics Approach’, *World Development*, 18 (7), 1990, 990.

6 Andreas, P., ‘Illicit International Political Economy: The Clandestine Side of Globalization’, *Review of International Political Economy*, 11 (3), 2004, 642.

In other words, state intervention creates a formal economy, and by extension, an informal economy is an economy that exists outside the regulatory framework of the state.<sup>7</sup> The emphasis on the regulatory role of state institutions has particular resonance in fragile environments, where conflict and fragility have eroded the state's ability to enforce its regulatory regime.

One important caveat is that the formal and informal economies should not be treated as discrete spheres of economic activity.<sup>8</sup> Globalised value chains and labour markets rely on the “value-adding symbiotic relationship”<sup>9</sup> between the informal and formal sectors. The phenomenon of informal employment in the formal sector is a clear illustration of the connections that exist between the two domains. Assuming a neat divide between the formal and informal economies is problematic, because it obscures these linkages.

### Why informal economies matter

There are several reasons why informal economies should be regarded as a matter of importance for international development and peace-building efforts in fragile contexts. In the first place, non-agricultural informal employment as a proportion of total employment is estimated at 70% in Asia, 66% in sub-Saharan Africa and 58% in Latin America.<sup>10</sup> Measured in terms of non-agricultural GDP, informal economies contribute 50%, 46% and 25% in sub-Saharan Africa, Asia and Latin America respectively.<sup>11</sup> These estimates should serve as a caution against treating the informal

economy as a marginal phenomenon. In fragile environments, the ‘real economy’ is more often than not an informal economy that dwarfs the formal economy. International actors therefore need to look beyond the formal sector, and consider the impact of the informal economy on the state, society and the economy in general.

Second, statistical evidence that informal economies correlate with weak public institutions<sup>12</sup> warrants a closer look at the nexus between fragility and economic informality. Understanding the impact of the informal economy, as an alternative mode of economic governance, on state capacity and governance processes is crucial for international strategies to promote good governance, strengthen the rule of law and curb corruption. Without that understanding, there is a very real risk that these strategies will yield disappointing results in contexts where a large informal economy sustains patronage networks, challenges compliance with state-sanctioned rules and undermines the state's revenue base.

Third, violent conflict can bring about an expansion of the informal economy, because it disrupts people's livelihoods.<sup>13</sup> Participation in the informal economy can form an important lifeline for conflict-affected populations.<sup>14</sup> At the same time, criminalised war economies, a “malignant form”<sup>15</sup> of economic informality, can take root in conditions of widespread conflict. The ambiguous duality of informal economies in conflict-affected environments needs to be taken into account when promoting transition towards a stable and peaceful societies. The informal economy can play a

7 Portes, A. and Haller, W., *op. cit.*, 410.

8 MacGaffey, J., *The Real Economy of Zaire: The Contribution of Smuggling and Other Unofficial Activities to National Wealth*. London: James Currey, 1991, 2.

9 Godfrey, P., ‘Toward a Theory of the Informal Economy’, *The Academy of Management Annals*, 5 (1), 2011, 268.

10 Charmes, J., ‘The Informal Economy Worldwide: Trends and Characteristics’, *Margin: The Journal of Applied Economic Research*, 6(2), 2012, 129.

11 *Ibid.*

12 Singh, A. *et al.*, *Inclusive Growth, Institutions, and the Underground Economy*, IMF Working Paper, 2012, 10.

13 Mallett, R. and Slater, R., *Growth and Livelihoods in Fragile and Conflict-Affected Situations*, Working Paper 9, Overseas Development Institute, 2012: 29.

14 Mallett, R. and Slater, R., *op. cit.*, 29.

15 Ballentine, K. and Sherman, J., ‘Introduction’, in: *The Political Economy of Armed Conflict: Beyond Greed and Grievance*, ed. Ballentine, K. and Sherman, J. Boulder: Lynne Rienner Publishers, 2003: 2.

shock-absorbing and therefore stabilising role in post-conflict settings but, equally, it can be a significant driver of conflict in conditions of intense competition for scarce economic resources.<sup>16</sup>

Finally, there is growing evidence that low economic productivity and poverty correlate with a high level of economy informality.<sup>17</sup> What is worrying in this regard is that globalisation seems to have fostered a shift towards lower-productivity activities that take place in the informal sector, especially in Latin America and sub-Saharan Africa.<sup>18</sup> An important consideration, therefore, is that the impact of inclusive development approaches in fragile environments will be blunted if informal economies and their effect on economic growth and productivity are left out of the picture. This observation is all the more relevant in view of the post-2015 development agenda, which pushes for a greater focus on the structural drivers of economic transformation.<sup>19</sup>

Put simply, whether the aim is to strengthen the capacity and legitimacy of public institutions, promote pro-poor and sustainable development patterns, or nurture peaceful and stable societies, the informal economy must be included in global policy dialogues about state-building, inclusive development and peace-building in fragile contexts.

16 For example, Schoofs, S. and Lara, F., *'Mindanao's Shadow Economies: Minimising Risks, Maximising Peace Dividends'*, Policy Brief, International Alert, April 2014.

17 Bluch, N.H. et al., *'The Informal Sector Revisited: A Synthesis Across Space and Time'*, Social Protection Discussion Paper Series No. 119, World Bank, 2001, 15 and La Porta, R. and Shleifer, A., 'Informality and Development', *Journal of Economic Perspectives*, 28 (3), summer 2014, 109-126.

18 McMillan, M. and Rodrik, D., 'Globalization, structural change and productivity growth', in: *Making Globalization Socially Sustainable*, ed. Bacchetta, M. and Jansen, M. World Trade Organization and International Labour Office, 2011, 50.

19 Evans, A. and Steven, D., *What Happens Now? Time to Deliver the Post-2015 Development Agenda*, Center On International Cooperation, New York University, 2015, 7.

## Maximum importance, minimum clarity

Making the case for policy engagement with informal economies is one thing, defining which policies are most appropriate is quite another. Indeed, over the course of four decades, prevailing policy attitudes have wavered between endorsing the informal economy as a "seedbed of entrepreneurs" or criminalising it as a "hotbed of racketeers".<sup>20</sup>

From the 1970s onwards, economic informality was predominantly equated with economic underdevelopment and distortion. That perception changed in the ideological climate of the 1980s, when the informal economy was reinvented as an entrepreneurial response to stifling state bureaucracies. The 1990s saw the pendulum swing back to a more pessimistic perspective, which framed informal economies as the cause and consequence of bad governance, collapsing states and intractable civil wars. At present a more optimistic view of the informal economy, focused on unleashing the assumed developmental potential of informal economies, seems to be in the ascendant.

Recent publications by the World Bank and the United Nations Development Programme (UNDP) confirm the current surge in positive policy attention being given to the informal economy, but they also demonstrate shortcomings in terms of policy guidance. The Bank's 2013 edition of its annual *World Development Report* argues that jobs are central to the development process. One of the report's more memorable assertions is actually found in its foreword: "*informal jobs can also be transformational*".<sup>21</sup> Yet the report does not spell out how the presumed transformational potential of the informal economy can be tapped.

UNDP's publication *Legal Empowerment Strategies at Work* (2014), on the other hand,

20 World Bank, *Sub-Saharan Africa: From Crisis to Sustainable Growth*, 1989, 5.

21 World Bank, *World Development Report: Jobs*, 2013, xiii.

aims to establish what works and why, when development actors engage with the informal economy. The report's premise: the traditional approach to formalising the informal sector has "*proven ineffective, and in some instances, even counter-productive*".<sup>22</sup> Drawing from a broad range of case studies, UNDP argues for a recalibrated approach that balances formal measures with informal practices. Because none of the selected case studies is situated in a fragile context, the question remains as to whether the proposed approach to the informal economy can actually be transplanted into fragile environments.

Both publications highlight the difficulty of moving from the conceptual to the practical in policy conversations about the informal economy. To some extent this problem stems from the conceptual perplexity that continues to surround the informal economy, which is also reflected in its "Cinderella status"<sup>23</sup> within development discourse. Compounding this problem is the fact that policy communities around the thematic pillars of inclusive development, state-building, sustainable growth and peace-building tend to appraise the role and policy relevance of the informal economy in a different manner. For instance, in the rationale of state-building, taxing the informal sector becomes an entry point to enhance the economic foundations of the state and its accountability towards citizens.<sup>24</sup> However, taxation may be a counter-productive strategy if the overarching development goal is to foster economic productivity and to protect already vulnerable livelihoods. Finally, policy formulation and programme development are also hampered by the cross-cutting nature of the informal economy, which renders it prone to fall through the cracks of the policy frameworks that guide international engagement in fragile states.

In sum, the conundrum that international actors continue to grapple with is that the informal economy combines "*maximum policy importance and political salience with minimum conceptual clarity and coherence*".<sup>25</sup>

## Rethinking responses to informal economies in fragile contexts

Fragile states represent the most challenging development context for international actors. Intervention strategies need to be attuned to the structural challenges that emanate from relatively weak and often exclusionary institutions as well as to the dynamics of violent conflict. The concomitant notion that international engagement in fragile contexts requires a recalibrated development approach also implies that conventional policy responses to informal economies may not be suitable for fragile situations.

Indeed, this policy brief argues that the established idea of formalising the informal economy needs to be carefully rethought in contexts where state capacity is severely diminished as a result of fragility and conflict. In general terms, formalisation entails a transition towards an economy that is regulated and protected by state institutions, whereby informal workers and enterprises are eventually incorporated into the mainstream economy.<sup>26</sup> The idea that formalisation of the informal economy should be the end goal has a strong hold within the realm of international development. This consensus has spawned a number of formalisation strategies that typically aim to facilitate access to the formal economy, promote regulatory reforms, expand social protection coverage, strengthen property rights and reduce transaction costs for informal operators.

22 UNDP, *Legal Empowerment Strategies At Work: Lessons in Inclusion from Country Experiences*, 2014, 14.

23 Duffield, *op. cit.*, 147.

24 Joshi, A., *Taxing the Informal Economy: Challenges, Possibilities and Remaining Questions*, IDS Working Paper 429, 2013.

25 Kanbur, R., 'Conceptualising Informality: Regulation And Enforcement', *The Indian Journal of Labour Economics*, 52 (1), 2009, 33.

26 ILO, *The Informal Economy in Africa: Promoting Transition to Formality: Challenges and Strategies*, 2009, iii.

The problem, however, is that formalisation presupposes a modicum of state functionality, something that remains decidedly absent in many fragile environments. Hence, formalisation may be a desirable development goal, but its feasibility in fragile environments needs to be put at the heart of the conversation about appropriate responses to the informal economy. At the very least, one-size-fits-all policy prescriptions ought to be avoided, precisely because they discount the context-specific dynamics of fragility *and* the informal economy, and could therefore do more harm than good.

Recognising the limitations and potential drawbacks of standardised intervention strategies is therefore a crucial first step in rethinking policy engagement with informal economies in fragile environments. Secondly, a much better evidence base is needed to guide policy and programming. In this regard, it is telling that the International Labour Organization (ILO) recognises that the evidence underpinning formalisation-oriented policy prescriptions remains weak.<sup>27</sup> There is thus a risk that the design of intervention strategies becomes more a matter of conviction than a matter of proof. What should also be clear is that an overly normative approach, with preconceived notions about the desirability or morality of informal economies, will merely result in tendentious policy paradigms that hinder effective engagement with the positive as well as negative effects of economic informality. Finally, policy engagement with informal economies in fragile situations requires an integrated approach. Without that, there is a real chance that conflicting policy directions and intervention logics will result in a fragmented and therefore ineffective approach to informal economies.

<sup>27</sup> ILO, *op. cit.*, 18.

## Recognising the political dimension of informal economies

Developing an effective approach to informal economies also requires development actors to recognise the political and social undercurrents that sustain patterns of economic informality in fragile environments. Unfortunately, informal economies are predominantly looked at through the lens of coping and survival activities, economic growth, social protection and, more recently, job-creation – largely owing to the dominance of multilateral agencies such as the World Bank, IMF, UNDP and ILO in policy conversations on the subject. This situation reinforces a tendency to reduce the informal economy to a purely economic phenomenon, at the expense of contemplating its intrinsically political character. The key point is that the informal economy exists for political as well as economic reasons.<sup>28</sup> Hence, it is imperative to steer clear of a reductionist view that perceives the informal economy solely in terms of economic (dis)-incentives for compliance with formal rules and cost-benefit decisions of informal operators.

In order to render intervention strategies geared toward addressing economic informality in fragile contexts fit for purpose, development actors need to acknowledge that:

*Informal economies are not ungoverned spaces.* It would be a mistake to associate the informal economy with a lack of regulation.<sup>29</sup> Indeed, informal economies manifest a considerable degree of governance, self-organisation and structure. Informal regulation emanates from a variety of non-state actors<sup>30</sup> and informal institutions

<sup>28</sup> MacGaffey, *op. cit.*, 9.

<sup>29</sup> Fernández-Kelly, P., 'Introduction' in: *Out of the Shadows: Political Action and the Informal Economy in Latin America*, ed. Fernández-Kelly, P. and Shefner, J. Penn State Press, 2006, 8.

<sup>30</sup> For instance, local strongmen, religious leaders and traditional chiefs, but also occupational associations, worker unions, informal workers' organisations, co-operatives or producer groups.

that are rooted in identity-based and interest groups, kinship-based networks and complex webs of clientelistic relations or personal ties. Hence, the informal economy can be understood as an alternative mode of economic governance outside the state.<sup>31</sup> Furthermore, “hybrid governance” is a more accurate depiction of actual economic governance<sup>32</sup> when the state has no exclusive regulatory authority over economic activities and non-state institutional arrangements provide a form of economic order.

*State engagement with the informal economy is complex.* Although the informal economy defies state regulation, it is not necessarily out of reach for the state, nor is state engagement with the informal economy necessarily antagonistic in nature. State agencies may decide to accommodate an informal sector such as street vending and waste-picking, which often are carried on in plain view of the state. This can even entail negotiated arrangements over taxation or regulatory policies between government actors and informal actors. Formal institutions can also coexist with informal regulatory mechanisms, as is the case with customary land tenure institutions that exist in tandem with state-sanctioned regulatory frameworks. Finally, state representatives themselves can engage in informal economic activities. Clearly, state engagement with the informal economy is not automatically geared toward regulation – it involves “*complex relations of competition, complementarity and complicity*”.<sup>33</sup>

*Political interests shape economic informality.* Informal economies cannot be considered in isolation from the actors that utilise it as an institutional resource – through rent-

creation, coercion and patronage – to pursue political and economic interests. Examples include public officials who manipulate formal rules and regulations for personal gain or politicians who turn a blind eye to the informal economy in return for electoral support from operators in the informal economy.<sup>34</sup> Thus, the informal economy is closely connected to the politic domain,<sup>35</sup> a point to be considered when looking at the gap between regulatory intentions (formalisation) and actual outcomes (persistent informality). After all, powerful political actors with a vested interest in maintaining the informal economy may be an important reason for the state’s inability to extend its regulatory regime to the informal economy.<sup>36</sup>

*Applying the labels ‘legal’ and ‘illegal’ can be problematic.* In situations where the state’s regulatory capacity is limited, the dividing lines between state and non-state, private and public as well as legal and illegal become increasingly blurred.<sup>37</sup> Informal taxation of small traders (e.g. paying a ‘special fee’ in return for a lower tax or protection from harassment) by state agents such as customs officials or police officers is an example of this. In fragile areas with weak state presence, it is the social legitimacy attributed to economic activities and the relative power of particular groups that define what is legal or illegal.<sup>38</sup> Cross-border trade forms the quintessential example of the gap that can exist between state-sanctioned legality and popular perceptions of legitimacy. Where states see cross-border flows of people and commodities that need to be policed and regulated, traders see legitimate opportunities for economic survival, which conform to well-established trading patterns

31 For instance, Meagher, K., ‘Social Capital or Analytical Liability? Social Networks and African Informal Economies’, *Global Networks*, 5 (3) 2005, 217.

32 Titeca, K. and Flynn, R., “‘Hybrid Governance,’ Legitimacy, and (Il)legality in the Informal Cross-Border Trade in Panyimur, Northwest Uganda’, *African Studies Review*, 57 (1), April 2014, 74.

33 Duffield, M., *Global Governance and the New Wars: The Merging of Development and Security*. London: Zed Books, 2001, 176.

34 On the informal economy as a captive source of votes see Joshi, A., *op. cit.*, 20.

35 Bayart, J. *et al.*, *The Criminalization of the State in Africa*. Oxford: The International African Institute, James Currey and Indiana University Press, 1999, 80.

36 MacGaffey, *op. cit.*, 39.

37 Pugh, M. *et al.*, *War Economies in a Regional Context: Challenges of Transformation*. London: Lynne Rienner Publishers, 2004, 8.

38 Titeca, K. and Flynn, R., *op. cit.*, 87.

that have existed since long before the post-colonial states came into being.

## Dilemmas for international actors

Following from the above, achieving a measure of effective engagement with informal economies hinges on an evidence-based and integrated approach that takes the political dimension of economic informality into consideration. Yet, this policy brief identifies four dilemmas that add to the challenge of developing effective intervention strategies.

### Engaging with informal economies in fragile contexts

Recognising that the informal economy is often a central feature of the political economy in fragile contexts still raises the question of what is an appropriate level of engagement with this phenomenon. Should its resilience and seeming imperviousness to state regulation be taken as a reason for accepting the informal economy as a second-best yet 'good enough' outcome in terms of economic governance, social protection and democratic accountability? Lack of clarity on what formalisation of informal economies situated in fragile contexts would entail in practice certainly reinforces such a position. The dilemma facing international actors, however, is that leaving the informal economy to its own devices could mean that local populations remain trapped in economic arrangements that are inimical to inclusive and accountable development processes, keep problematic actors such as warlords in power, lack social legitimacy, and are sustained through coercive violence. The attendant risk is that a hands-off approach to informal economies reinforces patterns of fragility and conflict, thus undermining international efforts to foster inclusive and peaceful societies.

### Enhancing state capacity: how much and for what purpose?

Bolstering state capacity remains an important plank of international support programmes in fragile situations. Yet state-building strategies need to clarify what role

for the state is envisaged with regard to the informal economy. Is the objective of increased state capacity to deter, control or support the informal economy? Questions about regulatory intent are intertwined with a more ideological dilemma which concerns the strategic orientation of the state towards the economy, with implications for the nature and extent of state engagement with the informal economy. Thus, imbuing fragile states with the capacity to maximise pro-poor development outcomes presupposes an interventionist state that is more likely to adopt a proactive development approach to the informal economy. In contrast, if the goal is to nurture a market-friendly state that limits itself to creating a level playing field for markets, the chances are that laissez-faire approaches to the informal economy will prevail.

### Accommodating hybrid forms of economic governance

Hybrid forms of economic governance pose several dilemmas for international actors. In the first place, in situations where non-state institutional arrangements wield more regulatory authority than the state, the practical question becomes not only how state regulation of the informal economy can be achieved, but also whether it should be attempted at all. The latter question is even more pertinent in fragile environments with latent conflict potential. As has been documented in the case of land-related conflicts in the Philippines<sup>39</sup> and Uganda,<sup>40</sup> violence can be triggered when formal institutions impinge on informal land tenure institutions that are linked to traditional authorities. Leaving non-state actors with significant authority in control over certain sectors of the informal economy may be a sensible strategy if the overarching goal is to stabilise volatile situations. In the long

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39 Gulane, J., 'Informal Land Markets and Conflict in Maguindanao', in: *Out of the Shadows: Violent Conflict and the Real Economy of Mindanao*, ed. Lara, F. and Schoofs, S. London: International Alert, 2013, 145-198.

40 Goodfellow, T., and Lindemann, S., 'The Clash of Institutions: Traditional Authority, Conflict and the Failure of 'Hybridity' in Buganda', *Commonwealth & Comparative Politics*, 51 (1), 2013, 3-26.



run, however, such a strategy may have problematic consequences for the state's ability to establish an inclusive and publicly accountable mode of economic governance. Finally, recognition that non-state institutions can fill the gaps left by an absent state can persuade international actors such as non-governmental organisations (NGOs) or companies to circumvent fragile state institutions altogether and engage directly with local institutional arrangements that appear to have the capacity and incentive to deliver development results. Here again, perceived benefits need to be weighed against the risks of shoring up exclusionary institutional arrangements and reinforcing drivers of fragility.

### Tapping the development potential of informal economies

A significant proportion of income-generation and wealth-creation occurs in the informal economy, a fact that sustains the increasingly prevalent notion that informal economies can be a potential asset for pro-poor economic development.<sup>41</sup> Tapping into that development potential seems sensible, but differing interpretations of the what and the how complicate matters. Taxing the informal economy represents a rather literal take on the idea of capturing its development potential. It chimes with the growing international focus on enhancing domestic resource mobilisation – by curbing illicit financial flows and strengthening tax administration – in order to finance post-2015 development agendas.<sup>42</sup> Standing in opposition to that is the idea of extending state support<sup>43</sup> to the informal economy, to achieve a measure of “productive

informality”<sup>44</sup> that can sustain livelihoods, generate incomes and boost economic growth. Obviously, taxing and supporting the informal economy are not mutually exclusive goals, but in fragile contexts the question is whether both can be achieved simultaneously. The dilemma is as follows: generating fiscal revenues from the informal economy requires state capacity, while state support for the informal economy requires fiscal resources and therefore taxation capacity. Given this conundrum, which intervention logic – support for or taxation of the informal economy – should take precedence?

### Thematic areas for further research

Clearly, at this stage there are more questions than answers when it comes to the phenomenon of economic informality in fragile contexts. There is thus a clear need to gain a better understanding of how and under what conditions informal economies actually thwart or promote the emergence of peaceful and inclusive societies. Generic use of the label ‘informal economy’ should be avoided, simply because it implies a level of uniformity across a broad range of fragile situations that does not exist in reality. Empirical case studies that contextualise and disaggregate the informal economy can be a helpful research methodology in this regard. Comparative assessments across informal sectors and fragile contexts represent another promising avenue for research. For instance, comparing the dynamics of artisanal mining across Colombia, Philippines and the Democratic Republic of Congo (DRC) can shed light on how differences in the character of regulatory authority and enforcement can lead to different outcomes in terms of economic governance, stability and violence. Ultimately, developing a basic typology of the key factors that shape trajectories as well as outcomes of economic

41 Chen, M.A., *Rethinking the Informal Economy: Linkages with the Formal Economy and the Formal Regulatory Environment*, DESA Working Paper No. 46, 2007, 1 and Sepulveda, L. and Syrett, S., *Out of the Shadows? Formalisation Approaches to Informal Economic Activity*, The Policy Press, 2007, 88.

42 OECD, *States of Fragility 2015: Meeting Post-2015 Ambitions*, 2015.

43 For instance through skills development and job policies, regulatory reforms and tax exemptions or creation of linkages with the formal economy

44 Fox, L., and Pimhidzai, O., *Is Informality Welfare-Enhancing Structural Transformation? Evidence from Uganda*, Policy Research Working Paper 5866, The World Bank, 2013, 3.

informality in fragile situations would be helpful for the purpose of guiding policy and programme design.<sup>45</sup>

More conceptual precision and analytical nuance is needed in the discussion about the nature and impact of informal economies in fragile settings. As a general principle, the manner in which informal economies shape governance, development and conflict patterns in fragile environments needs to be demonstrated rather than assumed. Among the various thematic issues that merit further research and discussion, four stand out:

1. *How do informal economies shape trajectories of state (de)formation?*

Achieving a measure of state consolidation remains the fundamental challenge in many fragile contexts. Informal economies can be important sources of wealth accumulation and political authority for a variety of political, economic and military entrepreneurs.<sup>46</sup> Understanding the implications of large informal economies for state formation processes in fragile contexts is therefore a research priority. One important question in relation to the phenomenon of 'hybrid governance' is what *kind* of state is being consolidated when non-state actors that utilise the informal economy as their power base, are brought into formal governance structures. In the case of Afghanistan, this strategy undermined an already weak state and had a corrosive effect on governance.<sup>47</sup> The opportunities as well as pitfalls involved in attempts to embed alternative regimes of economic governance in formal governance institutions need to be scrutinised further.

Furthermore, and despite a certain intuitive logic, the observation that a political economy of informality undermines state institutionalisation<sup>48</sup> may not always hold true. Indeed, massive expansion of informal gold mining in Eastern Mindanao, Philippines, appears to have consolidated the regulatory regime and fiscal revenues of the local state.<sup>49</sup> The case of Somalia suggests that informal economies can provide non-state actors with the institutional resources to either disrupt or create stable social orders.<sup>50</sup> Given the variable impact of the informal economy on state formation, a more nuanced view of the linkage between state fragility and economic informality is certainly needed.

2. *What are suitable and feasible strategies for formalisation in fragile contexts?*

Explicit policy guidance on how formalisation of the informal economy can be achieved in fragile states remains conspicuously absent.<sup>51</sup> An immediate research priority is to identify and subsequently draw lessons from examples in fragile contexts where this has been attempted. Among other things, this should generate better guidance on how domestic and international actors can strike a balance between formal interventions and informal practices in situations where state legitimacy and capacity is in short supply. Additional research should also foster a better appreciation of the peculiar challenges and risks associated with formalisation in fragile settings. For example, promoting state engagement with the informal economy through taxation can be

45 On this point see also Meagher, K. *et al.*, *Unravelling Public authority Paths of Hybrid Governance in Africa*, IS Academy Research Brief No. 10, 2014, 8.

46 Hesselbein, G., *Patterns of Resource Mobilisation and the Underlying Elite Bargain: Drivers of State Stability or State Fragility*, Working Paper No. 88. Crisis States Research Centre, London School of Economics and Political Science, 2011, 22.

47 Giustozzi, A., 'War and Peace Economies of Afghanistan's Strongmen', *International Peacekeeping*, 14 (1), 2007, 75.

48 Putzel, J. and Di John, J., *Meeting the Challenges of Crisis States*, Crisis States Research Centre Report. London: London School of Economics, 2013, 41.

49 Verbrugge, B., 'Undermining the State? Informal Mining and Trajectories of State Formation in Eastern Mindanao, Philippines', *Critical Asian Studies*, 2015, 1-23.

50 Reno, W., *Somalia and Survival in the Shadow of the Global Economy*, QEH Working Paper 100, 2003, 41.

51 Lange, P., 'Donors' Policy Engagement with the Informal Economy', unpublished manuscript, 2014, 8.

detrimental if it expands opportunities for predatory behaviour by state agencies, or, as is the case in northern Nigeria, exacerbates inter-religious tensions.<sup>52</sup>

It should be evident that intervention strategies derived from a singular model of formalisation are best avoided, but the question remains as to what alternative models exist that are more suited to fragile environments. The task at hand is to identify appropriate modalities for formalisation that actually benefit local populations instead of creating new rent-seeking regimes and destabilising already fragile situations. An important caveat is that formalisation cannot be automatically equated with the inclusion, protection and empowerment of informal operators. Hence, an essential question for in-depth research is how and to what extent formalisation strategies can actually provide the kind of protection, predictability and risk mitigation that non-state institutional arrangements provide, however inadequate they may be. Finally, if formalisation is to produce development outcomes that benefit poor and marginalised communities, the question of who actually benefits from formalising the informal economy needs to occupy front and centre stage in the discussion.<sup>53</sup>

3. *How can (support for) informal actors foster inclusive state–society relations?* Informal organisations such as occupational associations, informal workers’ organisations, cooperatives or producer groups play an important role in mediating interaction between state agencies and the informal economy. Self-organisation among informal sector operators can foster platforms for collective action as well as institutional channels for state–society interaction. For example, associations of women market traders in West Africa continue

to play an important role in channelling exchanges between the state and market traders over licensing, taxation and protection.<sup>54</sup>

Efforts to nurture a more inclusive and democratically accountable mode of economic governance should take into consideration the role and potential contribution of informal organisations. Questions remain, however, about structural barriers that impede self-organisation, what effective bargaining power for informal organisations entails and how it comes about, the risks of capture by self-serving political actors, and the exact mechanisms through which collective action can result in more inclusive and development-oriented state–society relations. There is also a need for a better appreciation of the potential pitfalls when local governments and international actors seek to empower informal organisations as potential vehicles for collective action.

4. *What drives the criminalisation of informal economies and how can it be prevented?* In contexts where state regulation is less present or less enforced, the dividing line between legal and illegal activities becomes less pronounced. The corollary of that observation is that in fragile environments it might be more accurate to assume a continuum rather than a strict divide between the informal and the criminal economy. In addition, while the nature of activities, commodities and actors in the criminal economy may be different, there is nevertheless considerable overlap in the key factors (e.g. geography, the relative strength of networks, regulatory capacity of the state, the role of corruption) that sustain the informal as well as the criminal economy.

In view of the growing attention paid to the destabilising effects of criminal

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52 Meagher, K., ‘Informality, Religious Conflict, and Governance in Northern Nigeria: Economic Inclusion in Divided Societies’, *African Studies Review*, 56 (3), 2013, 18.

53 Meagher, K. and Lindell, I., ‘Introduction’, *African Studies Review*, 56 (3), December 2013, pp. 57–76.

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54 Clark, G., ‘Gender Fictions and Gender Tensions Involving “Traditional” Asante Market Women’, in ‘Between Exit and Voice: Informality and the Spaces of Popular Agency’, *African Studies Quarterly*, 11 (2&3), 2011, 43–66.

violence in fragile settings, one of the main research priorities must be to acquire a better understanding of when, why and how informal economies become intertwined with organised crime and what the consequences are when this happens. In the case of Bolivia, when its drug economy penetrated the informal economy of La Paz, urban economic informality increasingly depended upon the logic of organised crime.<sup>55</sup> Pinpointing what exactly precipitates and facilitates criminal capture of an otherwise 'healthy' informal economy is crucial to prevent this from happening.

State neglect of the survival economy in the DRC's Kivu provinces and its subsequent institutional degradation has been identified<sup>56</sup> as the driving factor behind its gradual criminalisation. This implies that state support for the informal economy can play a role in insulating informal activities from the incentive structures of organised crime, but more clarity is needed on the practical measures required to achieve this.

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55 Blanes Jiménez, J., 'Cocaine, informality and the urban economy in La Paz, Bolivia', in: *The Informal Economy: Studies in Advanced and Less Developed Countries*, ed. Portes, A. *et al.* Baltimore: Johns Hopkins University Press, 1989.

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56 Jackson, S., 'Making a Killing: Criminality & Coping in the Kivu War Economy', *Review of African Political Economy*, 29 (93&94), 2002, 517-536.

## About the Conflict Research Unit

The Netherlands Institute of International Relations 'Clingendael' is a think tank and diplomatic academy on international affairs. The Conflict Research Unit (CRU) is a specialized team within the Institute, conducting applied, policy-oriented research and developing practical tools that assist national and multilateral governmental and non-governmental organizations in their engagement in fragile and conflict-affected situations.

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## About the author

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