

## Informal economy and entrepreneurship

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### **Abstract:**

The informal economy contributes strongly to production, consumption, employment and income generated in developing countries. It is a means of livelihood for a majority of low income citizens, socially marginalized and is an important mean of survival for unskilled people in countries without good social safety nets and unemployment insurance. For this reason, emerges a new interest to define measure and study the informal economy to better understand its scope, its impact and its contributions to the economy and society. Furthermore the pooling of efforts to “formalize” the sector and introduce it to formal economy is to be taken.

**Keywords:** Informal - creation -entrepreneurship.

**«When two forces unite, their efficiency double.»**

Isaac Newton

### **1. The informal market**

The Conference<sup>1</sup> (ILO, 1993) points out that the informal sector is characterized in general: “As a set of units producing goods and services with the primary objective of generating employment and income for the people concerned. These units, with low levels of organization, operating on a small scale and specific way, with little or no division between labor and capital as factors of production. Labour relations, where they exist, are based mostly on casual employment, kinship or personal and social relations rather than contractual arrangements with proper guarantees.”

Then it offers the statistical definition: the informal sector is regarded as a set of production units which constitute an element within the System of National Accounts (SNA), the household sector as individual companies.

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<sup>1</sup> <http://www.ilo.org>

Individual companies are different than corporations and quasi-corporations on the basis of their legal status and the type of accounts they hold. As individual companies they are not totally separate entities, independent of the household or household member who owns it. They do not have a full accounting procedure allowing a clear distinction between the company's production activities and other activities owner.

The informal sector is defined independently of the workplace, the importance of assets, the duration of the activity and its in primary or secondary activity, to include:

Firstly informal enterprises of own-account workers who may use unpaid family workers and casual employees: for operational reasons and according to national circumstances, this segment includes all businesses to be own account, only those not registered under specific forms of national legislation (tax laws or social security, professional bodies, or other laws and regulations)

Secondly the informal employers that may employ one or more employees on a permanent basis and that meet one or more of the following criteria: size of the institution less than a certain number of jobs (defined on basic minimum thresholds incorporated in national legislation or statistical practice), non-registration of the company or non-registration of its employees.

The first elements of the definition (and in particular the reference to the characteristics of the economic unit and not those of the individual), emerges the reason why the definition focuses on the informal "sector" and not on the non-informal employment: the international definition aims to enshrine the informal sector in the System of National Accounts, into the institutional sector of "households", and not in reference to any of "dualism". This is because the informal sector concerns the production units so it is possible to insert it as sub-sector in the household sector.

From the perspective of the ILO survey statisticians, it is clear that the criteria are not only the more operational, but they are also consistent with the structural and functional characteristics of the informal sector and help identifying trends of a specific segment of the labor force in relation to the ability (or inability) of the state to enforce laws and regulations it enacts. We can distinguish the following:

- Independent-employment (consisting of individuals working on their own account without employing permanent staff but possibly employing family helps and casual employees)
- Self-employment (which consists of the previous category but including family helps)
- Micro-enterprises (consisting of informal enterprises employing permanent employees below a certain level that the Delhi Group of the United Nations Statistical Commission recently set at 5 employees).

## 2. The informal market in Algeria

Worldwide, the informal sector can be analyzed by the data. Without trying too hard to deepen the analysis, we will present three African countries summarily including Algeria illustratively. An overview of the statistics, from one side, we can view that Africa leads with a very high informal economy (including the highest, Nigeria with 80%) and on the other side, the OECD countries with rates significantly below (including the lowest, 9% for Switzerland).

### Informal economy in three African countries

	Algeria	Egypt	South Africa
Informal economy as% of GNP 1999/2000	34,1 %	35,1 %	28,4 %
Informal Economy (US \$, billion current prices 2000)	172,6	349,8	348,3
Informal economy GNP / capita	538,8	523,0	857,7

Source: 2002 World Bank.

### Informal market in Algeria (key data)

- More than 50,000 participants
- Nearly 2,000 informal markets
- A tax loss of 10 million Euros, with five (5) billion in taxes on the added value at which it is appropriate to add the financial losses for social insurance funds.
- 14 billion dinars, (10 billion dinars by the Ministry of Commerce and 4 billion dinars by the Interior Ministry mobilized to eradicate the informal market).
- Informal employment rate at nearly 50% of total employment (rate is still increasing, informal employment includes employment in excess in the formal sector enterprises and employment in the informal sector and household enterprises).

## 3. The entrepreneur and the informal economy

The informal economy contributes significantly to production, consumption, employment and income generated in developing countries. It is also a means of livelihood for the majority of poor, unskilled, socially marginalized populations and is an important means of survival for people in countries without good social safety protection and unemployment insurance.

For this reason, in recent years there has been a new interest to define measure and study the informal economy to understand its scope, impact and contributions to the economy and society in developing countries.

The definition makes it a point to distinguish between informal sector activities of other non-observed economy activities such as the illegal production and household production for own consumption only.

Street vending or selling on public areas (sidewalks and public places) generally called “informal traders” constitute a large proportion of enterprises in the informal sector.

Regarding the contribution of informal enterprises to productivity growth and economic development, two different points of view can be cited:

- Based on a McKinseystudy, unofficial enterprises are considered a “threat” to formal enterprises and as an obstacle to economic growth. Obstacles to growth come from two channels:

- The small informal enterprises lead to inefficient production,
- Their desire to remain small to avoid detection by the authorities.

- The other point of view is drawn from the work of the Peruvian economist Hernando de Soto Polar pioneer in the field indicating that unofficial businesses are hampered by a number of tax and regulatory requirements that impede formalization. To improve this, appropriate measures in the tax reform, regulation, reducing barriers to entry and access to the necessary funds can allow these entities to contribute to economic growth.

The same study finds:

- First and within the same sector, informal enterprises operate about 50% below the average level of productivity of the formal sector.

- Second, that the cost advantage which informal businesses benefit because of tax evasion and regulatory non-compliance gives them an advantage over formal businesses, allowing them to encroach on the part of the formal sector market. Formal sector firms are therefore subject to unfair competition which reduces their incentive to invest, expand and improve productivity.

In addition, low tax revenues because of the large informal sector may result in a stricter taxation of the formal sector.

### 3.1. Informal Economy

According to the British weekly magazine *The Economist*<sup>2</sup>, the informal economy (combining illegal work and the product of illegal activities such as drug trafficking and prostitution) would represent 9,000 billion dollars worldwide, almost the equivalent of the US GDP. This result is based on a study by Professor Friedrich Schneider of the University of Linz, Austria. The study shows, however, important ideological flaws: all developed

<sup>2</sup> *The Economist*» Economie informelle : les trous noirs du PIB du 28 août 1999.

economies where taxes amount are high are affected by a strong informal economic coefficient. Thus, Switzerland, which is one of the world's leading tax havens, is nevertheless affected the weakest of informal economic rate (9%), due to the weakness of its taxes, while the questionable source of money circulates merrily.

Developing countries are ranked according to their "excessive" consumption of electricity, that is to say unusually high given the level of GDP. The method is crude, but gives Nigeria and Thailand leading with a rate close to 80%, which seems acceptable. France is credited with an informal economy equivalent to 14, 9% of its GDP. The European Commission had established a range of 4-14% depending on several assumptions. Rates well distant of the 3.5% estimated by the INSEE for the year 1998. Summarizing the results of previous reflections, the Conference (ILO, 1993a and b)<sup>3</sup> recalled that the informal sector is characterized in general:

- "As a set of units producing goods and services with the primary objective of generating employment and income for people concerned. These units, with low levels of organization, operating on a small scale and specific way, with little or no division between labor and capital as factors of production. Labour relations, where they exist, are based mostly on casual employment, family or personal and social relations rather than contractual arrangements with proper guarantees."

Then it offers in the statistical definition:

- The informal sector is regarded as a set of production units which constitute an element within the System of National Accounts (SNA), the household sector as individual companies.

The OECD manual<sup>4</sup> (2002) distinguishes four components of the non-observed economy (including the informal sector) since the unmeasured activities due to deficiencies in statistical systems have received adequate treatment:

- Underground production,
- The illegal production,
- The production of the informal sector,
- Production for own final use.

3 BIT, 1999a, Travail Décent, Rapport du Directeur Général, Conférence Internationale du Travail, 87ème session, Genève, BIT.

BIT, 1999b, Le programme InFocus du BIT sur la sécurité socio-économique, IFP-SES, Genève.

4 <http://www.oecd.org>

The Commission<sup>5</sup> (UNDP Commission on Private Sector and Development) stressed the importance to focus its attention on strengthening the domestic private sector, which “is more likely to lead to stable and sustainable growth models”. The Commission draws on the work of Hernando de Soto Polar highlighting the potential of entrepreneurship of the poor living in the informal economy. The latter emphasized the importance of agriculture where 75% of people living in absolute poverty derive their livelihoods. Women constitute the majority of micro-enterprises in the form of economy.

At the other end of the spectrum, the report of the committee said that foreign direct investment serves not only to provide substantial financial resources for investment, but also to:

- Provide expertise and know-how,
- Best practices in management,
- Open access to international markets,
- Operate technology transfer and innovation,
- Introduce competitive pressures in previously closed markets and
- Establish the main element for local businesses growth.

Hernando de Soto Polar work has focused on the role of land access in the emancipation and enrichment of disadvantaged populations and the importance of the underground economy in developing countries. Through its action in his country (Peru), founder of the ILD<sup>6</sup> (Institute for Liberty and Democracy), he initiated the agrarian reform in Peru which allowed access to ownership to 1, 2 million families and integrated 380,000 companies that worked on the black market to the formal economy. He exhibited his works in the thesis that the people of the South are rich but rich of a “Dead Capital”, they cannot mobilize for lack of an effective system of property rights. For de Soto Polar, recalling that “poor countries need solutions that developed countries have adopted at the nineteenth century, not the twenty-first century. ». An essential condition for the functioning of capitalism is the protection of property rights by the state. He explains that the legislative framework gradually established in the West has led to emancipation of the individual over the community, the right to property, generalization and standardization of the titles. The latter also allows a lower cost of transaction “in developing countries and former communist countries, people drive their pigs to market to sell them one by one, as they have for thousands of years done, while in the West, brokers bring to the market performances of their rights over the pigs. “<sup>7</sup>

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5 <http://www.undp.org/cpsd/documents>

6 <http://www.ild.org.pe/index.php/es/>

7 Hernando de Soto Polar, *Le Mystère du capital*, coll. Champs, Flammarion 2005, p. 78

### 3.2. Informal economy obstacle to the development of entrepreneurship

It is obvious to recognize the reason and the contributions of the informal economy in terms of livelihoods of the poorest. However, these same market conditions added to the high cost and uncertain regulatory framework by developing country governments (often corrupt) can marginalize the competitiveness of small and medium enterprises (SMEs) within the formal economy often to the advantage of larger established firms, often owned enterprises. A recent study by the World Bank in several countries concluded that the evidence concerning small and medium-sized enterprises, growth and poverty, “does not confirm the theory that SMEs are particularly effective job creators,”<sup>8</sup> this can be explained in part to the lack of competitiveness of SMEs. Entrepreneurs in the formal economy, are penalized by “subsidies” implicit in the informal economy (not subject to taxation, corruption and poorly regulated). Thus, “the most productive formal firms have difficulty capturing or taking market share from informal firms, and benefit from the economies of scale and increased productivity to develop. Therefore this situation of global environment, almost systematic corruption and a lack of skills affect the ability of entrepreneurs to grow a business. Thus they perpetuate dependency towards outdated and obsolete technology, and they find limits on access to financial instruments that can reduce risk and help to access foreign markets.

It may be used as solution through this state to make the economy formal by creating the conditions to reduce non-formality and change the composition of the private sector within the country over time, a solution that is based on the foundations of entrepreneurship and requires:

- Technological innovation and evolution in the sense of a knowledge economy based in the investment of human capital as a prerequisite for sustained economic growth and the initiation, growth and business productivity and thus allow better access to knowledge and skills;

- Banks and financial institutions must be able to effectively manage risk and allocate capital to finance productive investments. In terms of financing, however, in “many developing countries, the financial sector is dominated by the state (the case in Algeria) is incapable to be the catalyst function for development. But where genuine reforms are implemented, the results are fast and obvious. In addition, the internal national institutions (private and public) can specialize and operate in exclusive situations with limited mechanisms and pressure to encourage them to enter new markets and less coveted by major financial institutions and can be less specialized, such as loans or micro credit to SMEs;

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<sup>8</sup> Thorsten Beck, Asli Demirguc-Kuntet Ross Levine, « Small and Medium Enterprises, Growth, and Poverty: Cross-Country Evidence », World Bank Policy Research Working Paper 3178, December 2003, p. 3.



- The establishment of a framework without favoritism or bias but equal for companies competing in the market. Respect and maintaining these rules ensure that an entrepreneur has open access to markets and allow him to conduct his activities knowingly and effectively. The basic trust installed in economic procedures brings up a system that encourages entrepreneurship and attracts local skills, foreign skills and those of the diaspora needed to launch activities.

Improving the rules and procedures of land registration and the granting of land titles may be a prerequisite for access to financial resources. This proposal is largely influenced by the work of Hernando de Soto Polar, which examined in depth the entrepreneurial capacity in poor countries. A more favorable and dynamic environment must be created to strengthen the private sector and the establishment of legal procedures more transparent and more profitable for small and medium enterprises this provides an important legal framework for many people currently working in the informal sector and encouraging, and bring them to work as a small business in the formal sector.

We must carefully consider the fact to formalize property rights for the poor, in order to use these assets as collateral against the financing. This formalization could harm other primordial land uses which are equally important in terms of livelihood strategies for poor people, such as community land use. The issuance of title deeds should not undermine the status of women in family power relations by passing more and more official assets under male control. As noted by Roy Culpeper<sup>9</sup>, in his review of the book of de Soto Polar, "The Mysteries of Capital", if we want that such policies really benefit the poor, they must be accompanied by a profound agrarian reform, delivery a whole range of public services affordable education, health and infrastructure, an accessible credit on local credit markets displaying proper operation, and an open and transparent government, ready to challenge the trend the elite take advantage of formal property rights to increase and expand their own influence on the property as and the poor continue to pay their loans. Roy Culpeper also reports that de Soto ignores important dimensions disastrous repercussions of historical western experience regarding property rights to the English peasant or indigenous peoples of North America<sup>10</sup>

Research in Africa suggests that the informal sector has a complex relationship with the formal sector and the first could further promote the interests of poor material living and cost of inputs into the national mainstream economy. Without drastic changes in international aid and the debt burden in the conditionality of structural adjustment and global markets for commodities, African governments continue to rely on the informal sector "social safety

9 Roy Culpeper, « Demystifying Hernando de Soto: A Review of The Mysteries of Capital », site web de l'Institut Nord-Sud. <http://www.nsi-ins.ca/?s=roy+culpepper>

10 Culpeper, op. cit., p. 2.



net” to mitigate the economic calamity that strikes the poor. Several authors argue that the informal sector is not messy and anarchic as we think but rather creates its own rules and ways to mediate disputes.

#### **4. Enabling environment and to undertake training**

There are many possibilities and measures that can be taken to help young people in the informal sector to create their own company: - Lack of access to finance is considered one of the main obstacles in particular for young people. The banking sector and the financial sector should be aware of opportunities to do business with the young (and look through the perception of young entrepreneurs risk level, due to their lack of experience and capacity). Governments can take steps to stimulate the venture capital market (for example, tax incentives or incentives for private investment, creating investment funds) and provide guarantees of credit risk-related loans young entrepreneurs.

- Promoting joint projects and mentoring and counseling among young entrepreneurs and experienced businessmen.

- Delete tax revenue is an important instrument to stimulate investment and promote competitiveness.

- The Government and local authorities should facilitate the ability to register a business quickly and cheaply with rapid access to land.

- In a changing and complex environment from an economic point of view, the state should promote and encourage meetings, partnerships and networks where young entrepreneurs can rub shoulders with investors, advisors, experts and other entrepreneurs.

- Support measures, including in terms of information, sponsorship and finance.

Training future entrepreneurs means to equip them with improved skills and greater knowledge of business creation.

To achieve this, new entrepreneurs must learn, know their risk tolerance, know when to seize opportunities, and how to adapt the structure of their organization to eventually lead to success of their creation. Referring to the training approach to this discipline either classical or continuing education and exploring several relevant teaching practices designed to help learners learn better, to master the concepts of entrepreneurship, the tools and essential skills. The teaching techniques recommended for learners or students should include:

- A rational use of realistic assessments of risks and consequences of failure in line with what the learner has in terms of capabilities and personal address,

- The development of activities on individual business plans to emulate the commitment and experience of ownership by entrepreneurs,

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- Practical tips while creating their business plans and simulation of growth,
- Consolidation as a platform for learning key concepts of organizational structure, design and practice of change.

The concrete and living nature of these teaching techniques contributes to their knowledge and potential use by future entrepreneurs in their future organizations.

University education and training in entrepreneurship to enrich the experience became an important element in many business schools around the world to learn the aspects relating to the opportunities and challenges of entrepreneurship. Success in business education is linked by major researchers in the methodology and the subject areas of business schools. Concerns were expressed about business schools developing a teaching with little needed disciplines.

In the field of entrepreneurship, we must be concerned that the teaching and textbooks are appropriate and sufficiently meet the needs and expectations of future entrepreneurs. Arguments were presented and showed that teaching methods must reflect more on what the entrepreneur confronts in the difficult context of the formation of risk.

An appropriate use of planning technical activities in the training of potential entrepreneurs is needed. The concerns that must be raised for educators and entrepreneurship trainers are to observe training methods adapted to an essential goal: to provide learners with learning courses for their future projects consistent and permanent exit informal.

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