

Integrating the Informal Sector into the Formal Economy: Some Policy Implications

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Kayıt Dışı Ekonominin Kayıt Altına Alınması: Bazı Politika Önermeleri

Abstract

This study presents a survey of studies on informal sector with special emphasis on country experiences on integration of informal economic activities. Informal sector is a controversial topic since for many scholars, informal economic activities distort economy while according to others, it may contribute to economic growth. Yet, there is a growing consensus on the necessity to promote the informal sector on account of its importance with respect to employment and poverty issues alike. The previous experiences on integrating informal sector into the formal economy show that formalization schemes are not guaranteed from the viewpoint of the organized sectors, but rather by the benefits that access to formality may bring in fostering the development of informal activities and the relevant parties. Yet, oversight campaigns targeting informal activities are often overrated by the need to widen the tax base, cut down on tax evasion and punish illegality. In the Turkish economy context, the low levels of tax revenues despite high tax rates suggest that Turkish economy is on the right side of the Laffer curve. Therefore policymakers should seek ways to extend the tax base.

Key Words : Informal Sector, Integration, Employment, Poverty, Turkish Economy, Laffer Curve.

JEL Classification Codes : E26, H21, H26, O17.

Özet

Bu çalışma kayıtdışı ekonomiye ilişkin yapılmış çalışmalarını, kayıtdışı kalan ekonomik faaliyetlerin kayıt altına alınması ülke deneyimlerine özel vurgu yaparak ele almaktadır. Kayıtdışı ekonomi tartışmalı bir konudur; şöyle ki, kayıtdışı ekonomik faaliyetler, kimi akademisyenlere göre ekonomiyi bozmakta; bazı akademisyenlere göre ise ekonomik büyümeye katkıda bulunmaktadır. Öte yandan, kayıtdışı ekonominin istihdam ve yoksulluğa ilişkin öneminden dolayı, teşvik edilmesi gerektiği yolunda giderek artan bir görüş birliği mevcuttur. Kayıtdışı ekonominin kayıtlı ekonomiyle bütünleşmesi deneyimleri, kayıt altına alma tasarılarının örgütlendirilen sektörler açısından garantide olmadığını; ancak, kayıtlı ekonomiye olan erişimin kayıtdışı ekonomik faaliyetlerin gelişimini hızlandırması yoluyla ilgili taraflara fayda sağladığını göstermektedir. Öte yandan, kayıtdışı faaliyetleri hedef alan hatalı kampanyalar, vergi tabanını genişletme, vergi kaçırmayı azaltma ve yasadışı cezalandırma gereğine fazlaca önem vermektedir. Türkiye ekonomisi çerçevesinde, yüksek vergi oranlarına rağmen düşük olan vergi gelirleri, ekonominin Laffer eğrisinin sağ tarafında olduğunu göstermektedir. Bu sebeple, politika yapıcılar vergi tabanını artırmanın yollarını aramalıdır.

Anahtar Sözcükler : Kayıt Dışı Ekonomi, Bütünleşme, İstihdam, Yoksulluk, Türkiye Ekonomisi, Laffer Eğrisi.

1. Introduction

Since the 1970s, the informal sector has grown remarkably in many developing countries. As the informal sector has grown, it also imposed many scholars to a new challenge- to revise the former definitions of informal sector over and over.

The earliest work on informal sector is Hart (1973), which defines the informal economy to be composed of economic activities in which the workers operate in unregulated markets, use labor intensive technology and local resources, and learn their business skills outside the school. Accordingly, the scale of production is small in the informal economy. Furthermore, enterprises are often family owned and minimal amount of capital is required. Finally, informal business makes it relatively easy to create a job in the informal sector.

In another pioneering work on informal sector, it was highlighted that the informal activities are not the result of unemployment, but rather, they are the result of having to make a living with inadequate income from the formal employment (ILO, 1972). This feature of informal activity is asserted to be common in less-developed countries.

In succeeding works, informal sector activities are stated to be the consequence of pressure exerted by labor surplus for scarce good jobs which therefore lead to search for low-productivity income solutions by producing or selling anything that provide survival (Tokman, 1995).

Another contributing factor to informal economic activities is increasingly unstable demand, which hence necessitates the modern enterprises, to introduce more flexible productive systems and decentralize productive and labor processes in order to cut production costs and externalize demand fluctuation (Portes et al, 1989; Portes, 1996).

Recent research also focused on the importance of informal sector's operation beyond the prevailing legal and institutional frameworks (De Soto, 1986). However, a conclusion has not yet been reached on whether operating outside the institutional boundaries is the cause or the consequence of the informal economic activities (Tokman, 2001).

Another attempt to define informal sector regards the role of state in distinguishing between formal and informal sector. More specifically, formal sector is subject to regulations such as tariffs, quotas and selective monetary controls, whereas the informal sector does not have access to such benefits or formal credits (Moser, 1994).

Informal sector can also be defined as small-scale units engaged in the production and the distribution of goods and services with the primary objective of generating employment and incomes to their participants notwithstanding the constraints

on capital, both physical and human and also technical know-how.

A final definition is Rakowski (1994) where informal sector is characterized by small-scale firms, workshops and micro enterprises that are illustrated by use of low capital inputs and intensive labor, mostly self-employed workers, unprotected work conditions, extralegal activities, and lack of an accounting system. Informal sector is therefore recognized by the lack of separation between labor and ownership of the means of production.

Even though efforts to explain the informal sector have been varied over the years, the motive of survival has been continuously seen as a major factor in the development of informal activities. Yet, there is also an increasing amount of informal activities generated by the motive of decentralization, particularly in the context of rapid economic opening which therefore places this extra-regulatory behavior an important aspect in terms of analysis and policy implications.

Despite the different definitions adopted, the characteristics of the informal sector are similar in terms of scale of operation, use of technology, capital intensity such that the informally operating enterprises are small, use unsophisticated technologies, have low capital requirements per worker. Informal sector also features limited sharing of the ownership of the means of production and a majority of waged workers laboring without contracts and protection. Hence, the mix of the following factors can best explain the persistence of the informal sector. The rate and pattern of growth, including the labor-intensity and sectoral composition of growth; economic restructuring or economic crisis, including privatization of public enterprises and cutbacks in public expenditures; and global integration of the economy, including the restructuring of global production through outsourcing or subcontracting help to explain the persistence and expansion of the informal economy. However, urbanization and globalization in particular are seen as major factors that contribute to the process of informalization. More specifically, many of those who migrate to cities in search of jobs rather find work in the informal economy. Similarly, global integration and competition also seem to be associated with the erosion of both the employment arrangements of workers and the competitiveness of micro businesses. Therefore, home-based production at lower cost as subcontractors to large formal businesses are of common practice in today's economy.

After this brief introduction, the aim of this paper is to present a survey of studies on informal sector with special emphasis on country experiences on integration of informal economic activities. Following the overview on informal sector in this section, we will continue with discussing different views about informal sector in the following section. In the third section, we will provide some basic figures and facts about the informal economy. Consequently, we will discuss different approaches proposed for the integration of the informal economy to the formal economy as well as the strategies to regulate the informal sector. In the next section, we will briefly mention about the international experiences in integration process. Following that, we will discuss the tax

policy implications of informal economy and integration. Finally, the paper will conclude.

2. A Closer Inquiry to the Informal Sector

As the informal sector has expanded to meet the needs of more and more people, it has become a focal of attraction in the economic literature. According to one extreme view, informal sector is believed to stall formal economy while on the other extreme; it may foster the economic growth. A more systematic approach to study the informal sector is based on structuralist view, the underground economy view and the legalist/neo-liberal view.

The structuralist view, which is sometimes called the ILO-PREALC approach or the neo-classicist approach, perceives the informal sector as a solution to poverty and economic weaknesses in developing countries. According to this view, informal sector creates employment, contributes to capital accumulation while also encouraging domestic production. The structuralist view also acknowledges that economic development is nevertheless provided by the expansion of the formal sector but this view also asserts that informal sector enhances the formal sector in maintaining development. Therefore, the state should intervene to boost the informal economy since informal economy improves the welfare of the poor without hurting the rich (Moser, 1994).

The underground economy approach, contrary to the structuralist view, opposes the informal economy. This view perceives the informal sector as economically beneficial to capitalists while trapping workers in unfavorable labor conditions. The underground economy view claims that formal economy regulations have made labor force threatening and expensive for capitalists. In order to be exempt from these burdensome regulations therefore, capitalists choose to go underground thereby achieving immunity from legal restrictions. Hence, the informal economy benefits the capitalists but not the workers.

Finally, the legalist/neo-liberal view conjectures that the informal sector generates income for the national economy and promotes the well being of the poor. This view states that the informal sector improves a country's human resources since the poor becomes skilled as employment is created in the informal sector. However, this view also asserts that the gains to the economy of the informal activities only accrue if the state removes all the restrictions from the economy, including taxes and legislations especially on labor. Even if the state would not be completely neo-liberal, the informal sector would still serve to the interests of the overall economy by operating as a safety valve for easing potential social conflicts (Portes, 1996; Bromley, 1994).

3. Some Basic Facts About the Informal Economy

Informal sector has become a major source of employment in many developing

countries. More specifically, Latin American countries witnessed an informal employment rate of 40% in 1980s. (Rakowski, 1994; Aguilar, 1995). The growth rate of the informal sector in Central America surpassed the growth rate of the formal sector during the 1970s. By 1997, informal sector provided about 57 percent of total urban employment in Latin America (ILO, 1999).¹ Informal sector has been remarkably important in 1980s such that between 1950 and 1980, about 4 out of every 10 new jobs were created by the informal sector. On the other hand, since 1980, 80 out of 100 new jobs created have been informal. Hence, the percentage of informal workers with respect to non-agricultural employment grew from 40 percent in 1980 to 57 percent in 1997 (Tokman, 2001).

Until the Asian crisis in 1997, it was only the rapidly growing economies of East and Southeast Asia that experienced substantial growth of modern sector employment. However, in the aftermath of the crisis, most of these countries also experienced a decline in formal wage employment and a prominent rise in informal employment. Even before the crisis however, the informal sector accounted for nearly half of total non-agricultural employment in these regions, and as much as 80 percent in other parts of Asia and in Africa. In terms of urban employment, the informal sector accounted for well over half in Africa and Asia and a quarter in Latin America and Caribbean (Chen, 2001).

The contribution of the informal sector in income terms is significant in many regions. More specifically, in several African countries it accounts for nearly 30 percent of total income and over 40 percent of total urban income, the contribution of the informal sector to national income is also sizable. The share of the informal sector in non-agricultural GDP is between 45 to 60 percent (Chen, 2001).

The current picture of the informal sector presents a growth rate in micro enterprises (enterprises with 5 to 10 workers) surpassing the growth rate of the informal sector. About half of informally employed population works in micro enterprises. Even though, these enterprises provide a valid job creation option in terms of income offered, they still fail to tender acceptable working conditions in terms of job stability as well as labor and social protection.

As the informal sector has expanded, governments started to pay closer attention to the needs of the informal sector. For example, in Latin American countries, since the

¹ *The informal sector is defined as including self-employed with less than thirteen years of education, unpaid family members, employees and employers in establishment of less than ten employees (depending on country data availability) and domestic servants. In 1999, a new series was estimated, since improvements in national statistics allowed excluding from the informal sector establishments with more than five employees. The size of the informal sector in Latin America with this new series was 48 percent of non-agricultural employment in 1998, while 6 out of each 10 new jobs created between 1990 and 1998 were informal (Tokman, 2001).*

mid-1980s, governments could not ignore the informal sector such that in order to address informal sector concerns, several government institutions were established that devote resources to solve the problems of the informal sector.

Correspondingly, governments also focused on the growth of the informal sector during 1970s and 1980s as the informal sector was seen as an inexpensive way to create new jobs (McKean, 1994). More specifically, promotion of the informal sector was believed to provide a remedy for rising unemployment and homelessness. Consequently, the strategy to develop the sector has focused on the relaxation or removal of restrictions, with the provision of working capital and training programs for businesses operating in informal sector. Therefore, international organizations like United States Agency for International Development, Inter-American Development Bank, the World Bank, the Inter-American Foundation and finally the Ford Foundation subsidized the informal sector in developing countries through donations loans or micro credits (Otero, 1994).

4. Formalizing the Informal Sector into the Formal Economy

There is a growing consensus on the necessity to promote the informal sector on account of its importance with respect to employment and poverty issues alike. The aforementioned programs of the previous section are only some of the many, which aim at supporting informal activities in highly diverse national contexts. More specifically, policy measures are taken with the active support of social actors, in particular among entrepreneurial and trade union organizations. These measures are also backed with the view that promoting informal sector is especially viable and profitable during economic downswings. However, the effectiveness of the policy measures for the promotion of the informal sector is controversial. While such measures are often adequate on individual basis, they fail to be sufficient and only produce limited effects on a more comprehensive level.

The absence of an agreement on defining informal sector contributes to the decreased effectiveness of the promotion programs. Since informal sector has grown too heterogeneously, its complex nature made it increasingly difficult for one to adhere to one single strategy to implement for integrating it with the formal economy.

Integrating the informal sector into the formal economy is an alternative to designing a survival support strategy conceived as a policy to fight poverty with a welfare bias (Tokman, 2001).² Integration of the informal sector into the formal economy may be achieved through various but complementary ways. The widespread view on integration favors a three-pronged approach. More specifically, the first approach consists of

² *The terms formalizing, integrating or incorporating are used interchangeably in this context.*

providing support to help the productive development of micro enterprises by facilitating their access to the market and productive resources through the means of credit programs, as well as training and promotional programs, which strengthen organization skills and marketing practices.

The second approach involves the social welfare of the informal workers and as such, policy options usually get mixed with poverty alleviation policies. The third approach focuses on the regulatory framework of the informal sector. This approach considers the informal sector activities to be generated not as a result of regulatory inadequacies, but rather by the failure of the economic system to create enough productive employment. Yet, controversies exist among those who argue in favor of the view asserting that legislative or procedural changes are enough to overcome the present problems and those who deny the role of regulatory arrangements with respect to the economic activities.

5. Strategies to Regulate the Informality

The factual evidence suggests that informal sector is not a black market and the formal sector is not a white market. Gray areas prevail where in informal sector, limited compliance with regulations exist while tax obligations are neglected, and similarly in formal economic activities of countries with poor fiscal discipline and inspection capabilities, reckless compliance with labor law may be common. Therefore, gray areas in both formal and informal sectors might be widespread.

The Latin American experience indicates that due to built-in occupational instability, amendments to labor laws enable enterprises to draw atypical contracts usually characterized by high degree of precariousness. The Argentine experience during the 1990s show that almost all the new jobs created involved no contracts even offered by the large-sized enterprises. The percentage of workers without contracts is 38 percent, 68 percent, 40 percent, 32 percent, 18 percent and 24 percent of the total number of wage labor in Brazil, Paraguay, Peru, Colombia, Chile and Uruguay respectively.³ In addition to the existence of unregistered contracts as a regular practice, some contracts, even though they exist, may under declare wages in order to cut down the contributions for health and pension plans.

These evidences clearly indicate the complexity in finding a strategic option to integrate the informal sector into the formal economy. Yet, another issue arises as to whether gains from integrating would outweigh the cost from complying with the requirements of the regulatory system. More specifically, high cost of formality exists also confirmed by figures such that bringing an informal enterprise in line with regulations;

³ *These figures are borrowed from Tokman, 2001.*

entrepreneurs must go through at least eleven different administrative procedures in Brazil. Similarly, in Peru, Colombia, and in Chile, an entrepreneur would have to bear the cost of undergoing nine, six and four procedures respectively. Furthermore, a formal enterprise would have to pay at least ten, seven and eight different taxes and social insurance contributions in Brazil, Colombia and Peru respectively.

Finally, a study conducted in Peru estimated that only 35 percent of micro enterprises employing 5 or fewer workers and 60 percent of those employing between 6 to 10 workers could comply with the social security regulations (ILO, 1997). It was also estimated that full compliance would represent over a 50 percent cut of the profits of 75 percent of these enterprises. Additionally, the proportion of compliant enterprises would significantly drop as low as 35 percent if the burden of complying with income and other taxes were to be added. Clearly, depending on the number of regulations, the competence of the bureaucratic system and the nature of the country's administrative and institutional organizations, the number of procedure and the time devoted to meeting the requirements of the procedures might vary. Given these above facts therefore, strategic options seeking to formalize informality should concentrate their efforts on productive units that show some potential in terms of achieving productive modernization.

Regardless of the various factors involved, taking informal sector as the less advanced side of the overall economy and with the goal to integrate it into the modernization process, various alternatives can be considered. The first option in so doing would be to design an ad hoc regulatory system that would involve adopting dual or preferential regimes (Revilla, 1998) Yet, this approach is rejected as it may induce tax evasion. Furthermore, implementation of preferential schemes is believed to lead unfair practices in labor rights (ILO, 1991). Therefore, the implementation of single system rather than such a proposed dual system is preferred. Yet, the implementation of a single system with differential tax procedures like a non-taxable basic income, simplified tax declaration or tax estimations based on presumptive income may be adopted to promote informal sector and integrate it with the formal economy. Similarly, the system can be augmented with credit programs at preferential interest rates.

Another option to formalize the informal sector is through a non-exclusionary strategic option that consists in adapting formalizing requirements to bring them closer to the capabilities of informal entrepreneurs, in terms of the costs of formality and formalization procedures and machinery are concerned. Such a scheme would entail cutting down the cost of legalizing the informal activities without affecting the single regime principle. As such, simplifying bureaucratic procedures is another way of integration of informal sector with the formal economy. The current trend emphasizes the implementation of a single–registry window regime where the cost of formalization would be minimized though its feasibility is still debatable (Tokman, 2001). The single-registry window regime foresees creating a single authority that would facilitate the dissemination of information and avoid overlapping and sometimes contradictory regulations,

administrative procedures.

A final option for formalization is the recognition of property titles as a mechanism to have access to credit (De Soto, 1995). The proposal seeks to simplify the release of a legal property title and to adapt it to prevailing conditions of the ownership. Hence, the proposal also entails disregarding contractual preconditions and providing proof of property using alternative means of recognition such as long-term usufruct, calling on witnesses and having boundaries recognized by third parties that might have conflicting interests. Thus entitlement paves the way for integrating the informal sector since major obstacle to having access to credit is collateral requirement, which usually involve assets.

6. International Experiences on Integration of the Informal Sector

After discussing the various approaches offered for integrating informal sector to the formal economy, and also mentioning strategies for regulating the informal sector in the previous sections, this section will focus on country experiences on integration of the informal sector.

The Indian Experience

Access to global markets is critical to the economic security of many of the world's poor working in the informal sector. Likewise, in India, the informal sector workers include home-based workers, vendors, manual laborers and service providers by accounting for up to 70 percent of GDP and over 40 percent of exports. Additionally, 93 percent of the total labor force operates within the informal sector, and 60 percent of the informal sector workers are women.

The Self-Employed Women's Association (SEWA) of India is an example to how integrating informal sector activities take place. SEWA helps many Indian women meet their business needs. More specifically, in order to alleviate the barriers to business that Indian women face like laws and customs that discriminate against women, insufficient access to credit, lack of social benefits like health insurance and pension plans, lack of child care, lack of education and training and insufficient knowledge about export markets, SEWA has established several organizations. One such organization is the SEWA Bank, a cooperative with over 125,000 members that provide credit. Furthermore, other six self-financed organizations under the SEWA domain provide insurance, pensions, medical and child care for SEWA members. For education and training purposes, SEWA Academy was established where every year 20 thousand women participate to various education programs, focusing on literacy, training, research and communication provided by the Academy (ITC, 2003a).

In order to promote exports by providing access to national and global markets

and thus ensuring lasting stability, SEWA also set up a Trade Facilitation Center owned by the members themselves. The center standardized the production technology through quality control mechanisms, introducing common production centers and central designing.

SEWA uses technology to help anchor the process of integration as a means of providing business training and education, facilitating networking and improving quality management and production efficiency. It also develops information and training software both for skill building and to increase literacy as well.

SEWA also uses audio-visual media to connect with its rural members for training and capacity building, mentoring and export guidance. Thus networking plays an important role in the success of the SEWA. Networking is provided nationally as well globally through Global Trade Facilitation Center. This center is designed to strengthen, support and expand market opportunities for grass-roots producer organizations in the informal sector with a particular focus on women. The center also aims at aiding informal sector workers in lesser-developed countries.⁴

The South African Experience

The rapid expansion of South Africa's new black bourgeoisie has significantly altered the country's class structure. Simultaneously, the state and private sectors have embarked upon concerted programs to privatize and deregulate the hitherto heavily bureaucratized economy, and to ensure the survival of capitalism as the dominant mode of production. Such a program featured the promotion of black business through the semi-formalization of informal manufacturing activities in industrial parks where the environment is very different from that in the segregated urban townships from where they originated. The promotion of black-run informal businesses within industrial parks in white areas has initially had largely beneficial effects on them. The deregulated environment, incentives and support facilities provided by the parks have assisted development by partially overcoming existing constraints such as restrictive regulations and the lack capital and technology. Moreover, away from the restrictions imposed by the poverty of the township environment, the firms have benefited from wider access and new opportunities for diversification and expansion.

Yet, these businesses also displayed a high degree of internal differentiation while the quality of goods produced was also varied. On the other hand, the number of new

⁴ *Similar cooperatives were established in South Africa, Nepal and Cameroon where self-employed women gather to overcome economic and social vulnerability by providing business trading, establishing contacts with other networks and designing export strategies for its members (ITC, 2003b; 2003c; 2003d).*

jobs created over a short period was far higher than expected on the basis of experience with conventional informal sector activities. Furthermore, the interaction with formal and informal operations increased as a result of assistance and promotional efforts in the parks. Moreover, little evidence was found to support the view that informal sector was subordinated to and exploited by the more powerful formal sector. On contrary, the noteworthy level of subcontracting was found to contribute significantly to increased turnover and the regularity and reliability of income for many firms. These small firms thus seemed generally complementary rather than subservient to the formal sector.

The Mexican Experience

Between 1993 and 1994, the government of Mexico City implemented the most ambitious market construction program since the 1960s in the downtown area known as the Historical Center. This area, designated as a cultural and historical landmark by the UNESCO, has been until recently taken over by more than 10,000 street vendors that disloyally competed with formal commercial businesses, evaded taxation, sold contraband goods, and presented a health threat for the general public due to lack of sanitary facilities and health department supervision of food stalls.

The market construction program was therefore designed to remove vendors from the street, to make the vendors subject to tax codes and health regulations. The planning of the market program was taken over by an agency- COABASTO (Coordinacion de Abasto y Comercio Popular), which was given full authority to negotiate credit guarantees to secure financial backing for the project. A special credit institution, the Fondo de Desarrollo Economico y Social del Distrito federal (FONDEDIF) was opened as a subsidiary of Nacional Financiero, S.A. – a state bank, to manage the financial side of the program, allocating about 175 million US dollars at 1994 exchange rates, while still most of the financing was provided the Banco Nacional del Comercio Interior, another state bank.

Since street vendors generally neither had a proof of their income nor were they able or willing to put up other property as a collateral to the debt they were to incur which ranges between US\$5,000-10,000 depending on the size and type of stall, of which 10 percent was to be paid as a down payment, with monthly installments extended to over 6 years, the city had to function as the guarantor of all the financial credits provided by the market program. Thus the market program exposed the city to incur a tremendous financial risk.

Actions Taken by International Organizations

During the 1980s, various trade unions, grassroots organizations, and non-governmental organizations working with home-based workers and street vendors began to establish linkages. In the mid-1990s, these organizations gathered to form international alliances of women in the informal economy: one of home-based workers called the

HomeNet, the other of street vendors called Street Net.

In view of the increased power of joint action of grassroots organization, research institutions, and international development agencies, the founders of HomeNet and StreetNet and representatives from United National Development Fund for Women (UNIFEM) established a global network to promote better statistics, research programs and policies in support of women in the informal economy. This network, called WIEGO (Women in Informal Employment: Globalizing and Organizing) was founded in early 1997. WIEGO identifies five priority areas for its work: urban policies to promote and protect street vendors, global trade and investment policies to maximize opportunities and minimize threats associated with globalization for home-based workers, social protection measures for women who work in the informal economy, organization of women in the informal economy and their representation in relevant policy making bodies and institutions at the local, national and international levels, and statistics on the size and contribution of the informal economy.

WIEGO has affiliates in over 25 countries as well as project partners and activities in over a dozen countries. At the international level, WIEGO has been effective at raising the visibility of the informal economy in public policy fora and at working with the ILO and the UN Statistics Division to improve data on the informal economy.

7. Tax Policy and the Informal Sector

The analysis of this paper so far demonstrates that informal sector activities are inherently related to the development of the official economy such that these activities are more peculiar to less developed countries. The corollary that follows this argument therefore stresses the need to eradicate underdevelopment in order to integrate the informal sector activities with the official economy. This naïve approach is related to the Keynesian cure for recession that proposes stimulating demand. Yet, many under developed countries are also prone to high inflation. Obviously, anti-inflationary policies prescribe curbing demand, but it is obviously impossible to do decrease inflation by restricting demand yet stimulating demand both at the same time. This led Robert Mundell to propose, in 1971, that the job of ending inflation be assigned entirely to monetary policy (similar to what is now called “inflation targeting”, while the toolkit of fiscal policy should be expanded to include a microeconomic focus on the supply side--i.e., through tax incentives, privatization and deregulation to enhance potential supply.

Previous studies on estimating the size of the informal sector in the Turkish economy underline the fact that informal economic activities in Turkey have been mostly driven by high inflation, unstable economic environment as well complexity of the tax scheme in addition to high tax burden (Us, 2004; Ilgın, 2002; Sarılı, 2002; Önder, 2001; Mavral, 2001; Ögünç and Yılmaz, 2000; Gümüş, 2000; Özsoylu, 1998; Toptaş, 1998). Even though a lower tax rate may motivate informal economic actors to integrate with the

registered economy, in the face of fiscal dominance, concerns over raising high tax revenue have been so predominant that such a proposal to lower the taxes may well seem like a radical action. Yet, there is evidence that lower tax rates lead to more rapid expansion of investment, increased productivity, more employment opportunities and hence increased economic growth (Marsden, 1983). The same author also concludes that expansion of the tax base leads to higher tax revenues and therefore lower budget deficits.

Reynolds (1985) notes that among the 20 lowest income countries according to World Bank categorization, the individual income tax accounts for only 7 percent of the government revenue. By presenting evidence on the inverse correlation between the corporate profits tax and the growth of the private economy or capital formation, the author concludes that in highly taxed economies, strong Laffer curve effect is present. Additionally, it is also documented that in high-tax industrial countries like Sweden, Belgium and Netherlands, real tax revenue growth has not been experienced due to little growth of real GNP whereas in lower tax economies, a higher economic growth was observed.

The tax statistics provide evidence that Turkey has continuously been below the OECD average in terms of the share of tax revenues in GDP. Yet, in terms of the highest statutory income tax rate, Turkey falls above the average region (Tables 1-2 in Appendix). These evidences therefore providence evidence that tax rates in Turkey are above the optimal level in the sense that excessive tax rates distort the economy and encourage tax avoidance and even evasion.

As Lindbeck (1983) emphasizes, higher marginal tax rates create disincentives for the intensity of work, the ambition to strive for promotion, the willingness to shift from one job or geographical region to another, and the desire to invest in human capital. Furthermore, the author also states that both households and firms may be then induced to substitute productive effort in the underground economy for work in official markets or search for tax loopholes. As Reynold (1985) notes, in order to avoid high tax rates, large-scale enterprises are often forced to be small enough to be either exempt from tax or to be exposed to lower tax rates. Overtaxed economies therefore revert to primitive technologies thus decreasing the potential productivity and increasing the informal economic activities.

8. Concluding Remarks

The formalization schemes proposed in the previous sections are not guaranteed from the point of view of the organized sectors, but rather by the benefits that access to formality may bring in fostering the development of informal activities and the relevant parties. Yet, oversight campaigns targeting informal activities are often overrated by the need to widen the tax base, cut down on tax evasion and punish illegality. Even though these objectives are valid, they are also believed to be ineffectual since the marginal tax

revenue would also require marginal cost of collecting it.

It is often debated therefore that instead of changing the regulatory framework in terms of bringing more penalties, there should be increased flexibility in order to provide the integration of the informal sector to the formal economy. The same principle also holds true regarding labor market regulations such that instead of punishing informal sector working group by depriving them from access to labor protection, having respect to certain labor rules would be more contributory for the integration process.

A similar argument is also valid in the recognition of ownership titles for the purpose of gaining access to credit. In the specific case of street vending, the recognition of ownership may be interpreted as providing a stable and lawful place of business, which is likely to reduce the cost of informality and provide access to new markets and productive resources.

Integrating the informal sector micro enterprises into the formal sector requires fundamental alteration of the behavior of the informal sector entrepreneurs. Even though these businesses operate in flexible ways, they are culturally unprepared to produce for demanding markets since the tradition of working in informal sector require doing business driven by the imperative of succeeding by any means. When incorporated into the formal sector however, these entrepreneurs will have to seek the benefit of pooling productive resources as well as associate with other producers in their efforts to gain access to the marketplace. Furthermore, rather than working on an individual basis, these entrepreneurs will be expected to produce with professionalism, in timeliness and in good quality. The micro entrepreneurs therefore will have to experience a cultural change when integrated to the formal sector.

The cultural change also concerns collective representation. Micro entrepreneurs do not join business or trade union organizations. However, the integration process also requires these entrepreneurs to get acquainted with ways and means of collective representation when securing benefits.

In the more specific Turkish economy context, given the high empirical evidence on the tax aspect of the informal activities as well as the previous literature on promoting supply-side policies to integrate the informal sector with the formal sector, the policymakers should seek ways to extend the tax base. Even though, the low levels of tax revenues despite high tax rates suggest that Turkish economy is on the right side of the Laffer curve, further research should focus on a more comprehensive micro level study on tax regime. Yet, this is beyond the scope of this paper.

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Appendix

Table 1
Total Tax Revenues as Percentage of GDP

Member Country	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003
Canada	35.9	35.6	35.9	36.7	36.7	35.9	35.6	35.1	33.9	33.9
Mexico	17.3	16.7	16.7	17.5	16.6	17.3	18.5	18.9	18.1	19.5
United States	26.7	27.6	27.9	28.3	28.9	28.9	29.7	28.9	26.4	25.4
Australia	29.3	29.7	30.3	30.0	30.0	30.8	31.5	30.1	31.5	n.a.
Japan	30.0	27.6	27.5	27.9	26.8	26.4	27.5	27.3	25.8	n.a.
Korea	19.1	20.5	21.4	22.7	22.9	23.6	26.1	27.2	24.4	25.5
New Zealand	37.6	37.0	34.9	35.5	34.1	33.9	33.8	33.8	34.9	34.8
Austria	40.4	41.6	43.5	44.4	44.1	44.0	43.3	45.4	44.0	43.0
Belgium	43.2	44.6	44.9	45.3	45.9	45.3	45.7	45.8	46.4	45.8
Czech Republic		40.1	39.3	38.6	37.9	38.9	38.9	38.4	39.3	39.9
Denmark	47.1	49.4	49.9	49.8	50.1	51.5	49.5	49.8	48.9	49.0
Finland	44.6	45.1	47.4	46.2	46.0	47.0	47.3	46.1	45.9	44.9
France	43.0	44.0	45.0	45.2	45.1	45.7	45.2	45.0	44.0	44.2
Germany	32.9	38.2	37.4	37.0	37.1	37.7	37.8	36.8	36.0	36.2
Greece	29.3	32.4	40.2	34.0	35.8	37.0	37.5	36.9	35.9	n.a.
Hungary		42.4	40.7	39.0	38.8	39.1	39.0	39.0	38.3	n.a.
Iceland	31.5	31.8	33.0	32.9	34.8	37.2	38.3	36.5	38.1	40.3
Ireland	33.5	32.8	32.8	32.2	31.5	31.0	31.2	29.9	28.4	30.0
Italy	38.9	41.2	42.7	44.2	42.5	43.3	41.9	42.0	42.6	43.4
Luxembourg	40.8	42.3	42.4	41.5	40.2	40.1	40.4	40.7	41.8	41.6
Netherlands	43.0	41.9	41.5	41.9	40.0	41.2	41.1	39.5	39.2	38.8
Norway	41.5	41.1	41.1	41.8	42.7	40.4	39.0	43.3	43.5	43.9
Poland		39.6	39.4	38.8	37.6	35.0	34.3	33.6	32.6	n.a.
Portugal	29.2	32.5	32.3	32.8	33.3	34.0	34.3	33.5	33.9	n.a.
Slovak Republic					35.9	34.4	34.9	32.3	33.1	n.a.
Spain	33.2	32.8	32.6	33.5	34.0	35.0	35.2	35.2	35.6	35.8
Sweden	51.9	48.5	50.4	51.6	52.0	52.3	54.0	51.4	50.2	50.8
Switzerland	26.9	28.5	29.0	28.5	29.7	29.8	31.2	30.6	30.3	29.8
Turkey	20.0	22.6	25.4	27.9	28.4	31.3	33.4	36.5	31.1	32.9
United Kingdom	36.8	34.8	34.8	34.9	36.7	36.1	37.2	37.3	35.8	35.3
OECD Total	34.8	36.0	36.6	36.6	36.5	36.8	37.1	36.9	36.3	
OECD America	26.6	26.6	26.9	27.5	27.4	27.4	27.9	27.6	26.1	
OECD Pacific	29.0	28.7	28.5	29.0	28.5	28.7	29.7	29.6	29.1	
OECD Europe	37.2	38.6	39.3	39.2	39.1	39.4	39.6	39.4	38.9	
EU 15	39.2	40.1	41.2	41.0	40.9	41.4	41.4	41.0	40.6	

Source: OECD Revenue Statistics, 2004

Table 2
Highest Statutory Tax Rates in OECD Countries

Member country	Taxes on Income and Profits/GDP*	Tax Rate**
Switzerland	13.1	13.0
Norway	19.0	19.5
Sweden	17.7	25.0
Iceland	16.7	26.1
France	10.5	27.7
Canada	15.7	29.0
Spain	10.4	29.2
Czech Republic	9.7	32.0
Mexico	5.2	34.0
United States	11.8	35.0
Finland	18.6	35.5
Korea	6.2	36.0
Japan	7.9	37.0
Luxembourg	15.3	38.0
Slovak Republic	7.0	38.0
New Zealand	20.6	39.0
Greece	8.9	40.0
Hungary	10.1	40.0
Poland	9.5	40.0
Portugal	9.4	40.0
Turkey	7.7	40.0
United Kingdom	13.5	40.0
Ireland	11.1	42.0
Italy	13.8	45.0
Australia	17.4	47.0
Germany	10.1	48.5
Austria	13.0	50.0
Belgium	18.3	50.0
Netherlands	10.6	52.0
Denmark	28.9	59.0
OECD Average	12.9	37.6

*Taxes on income and profits as percentage of GDP is available only in 2002 for all OECD countries.

**Estimated rate for 2003

Source: <http://www.house.gov>

Gray shaded rows indicate countries with highest statutory tax rates that are above the OECD average. Countries that fall below the OECD average in terms of Taxes on Income and Profits to GDP ratio, yet remaining above the OECD average in terms of highest statutory tax rates are typed as bold face.