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# SHADOW ECONOMIES: INFORMAL AND ILLICIT MARKETS IN FRAGILE CONTEXTS

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## INTRODUCTION

Although informal economic activity is a global phenomenon, many developing countries face particular challenges linked to formal economic participation. These challenges have implications for revenue generation as well as governance more broadly. In addition, illicit markets linked to organized crime or terrorism often thrive in fragile contexts in which state capacity is low. 'Shadow economies' have a more multifaceted relationship to poverty alleviation, employment rates and economic productivity than is generally depicted. This brief examines linkages between illicit, informal and formal markets and the implications that shadow economies have for good governance as well as equitable development.

## FINDINGS AND IMPLICATIONS

The term 'informal economy' refers to markets employing unregistered workers whose labour is not taxed by the state and does not provide codified labour protection. Informal markets include both the self-employed and employment in formal organizations that is not recorded (i.e. construction or services). Informality is not necessarily illicit and often results from a lack of state-led regulation. In this regard, informal economies can serve as a source of resilience in fragile and conflict-affected contexts.

There are arguments for and against the formalization of informal markets. Not all informality is 'bad' for economic growth and informality does sometimes serve purposes not captured in traditional macroeconomic measures, such as the change in gross domestic product (GDP) over time. Formalization, then, is a process that should occur naturally when the market conditions are right (e.g. when states and businesses find it in their best interest).

Although informality often arises in the absence of state regulation or when state capacity is limited, states also voluntarily support informality when it benefits them. Fragility and parallel economies are not necessarily correlated. Even in the stable Soviet Union where regulation was high, there was a high degree of informality. If the state is illicitly profiting from the informality, through illegal mining or the expropriation of land, for example, it is unlikely to encourage formalization.

In many African countries with small economies, the social contract between governments and their citizens is often weak: Governments cannot amass sufficient income from taxes to offer services in return. Paying taxes is one way to increase one's personal stake in the society. Recent trends towards 'informalization' in relatively developed countries suggest that the need for government services and oversight may decrease as development increases, and that the need for government, namely the provision of basic social services and public goods, may be higher in relatively less-developed economies. The exact level of formalization that is necessary in different contexts at different development stages remains uncertain.

## RECOMMENDATIONS

**1. Policymakers should consider how informal markets fill a trust deficit before implementing formalization policies.**

- The informal economy is regulated by trust, which allows for relationships to be built between stakeholders even in the absence of the state.
- The informal economy does provide a certain level of regulation without state oversight: The penalty for non-compliance with these unofficial 'rules' is exclusion. However, informal regulation is not bound by legal standards and may reinforce market failures and externalities that preclude the participation of certain segments of society or inhibit growth beyond a certain level.
- Alternative regulation mechanisms include blockchain mobile payment technology and peer-review systems of enforcement that remove the government as regulator.

**2. Interventions that promote formalization should be considered in instances when the conditions are 'ripe'.**

- To assess the prospects for formalization, development actors should evaluate how the informal market is functioning (Who is benefitting and who is missing out?) as well as how the government, quality of governance and regime type are related with regard to the informal economy. Such an evaluation should also consider the costs (public and private) of formalization in the short- and long-term.
- Unemployment and underemployment are functions of the extent of formalization of labour, including subsistence agriculture.
- When citizens do not need to rely on governments for regulation, the state becomes increasingly obsolete and trust-based regulation takes on new forms. In these contexts, informality erodes public trust and governance capacity. Increasingly the degree of economic formalization may improve trust in state institutions.

**3. When formalization is determined to be the best option, changes should be phased in slowly.**

- Extending labour and other protections as incentives to attract informal businesses to register before implementing a system of taxation might ease the transition.
- Start incrementally by identifying informal sectors that could be formalized with relative ease. For example, in Kenya, the 'jua kali' sector of entrepreneurs began in the informal sector and is now regulated by government. Table banking is another example of small, informal businesses that could benefit from formalization.
- With each step towards formalization, communicate the benefits. For example, by providing equal access to competitive markets and labour and property protections, formalization can reduce marginalization and inequality.