



## **THE INFORMAL ECONOMY: A NEGLECTED AREA IN ISLAMIC ECONOMICS**

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### **ABSTRACT**

The informal economy has been neglected by Islamic economists. The neglect means the Islamic economic system being rebuilt is confined only to state and market domains. That existing paradigm is myopic. To understand and solve the real-world economic problems, we need to recalibrate and also focus on the informal economy. The purpose of this study, therefore, is to review the conception of the informal economy. With a better understanding of the concept, we hope that rebuilding of Islamic economics can become more holistic in approach. The informal economy is unique according to countries. The economic, political and cultural aspects have a strong influence on the dimensions of the informal economy. Based on the extant literature we also have identified the determinants of informal employment. The evaluation of the factors identified in this study reveals that government policies and efficiency, poverty issues, gender inequality, education and religiosity are the determinants of the informal sector employment. We then call for future research in Islamic economics to be geared toward understanding and addressing issues in the informal economy.

JEL Classifications: B5, D60, E26

Key words: Informal economy, Informal employment, Inclusiveness, Islamic economics, Employment

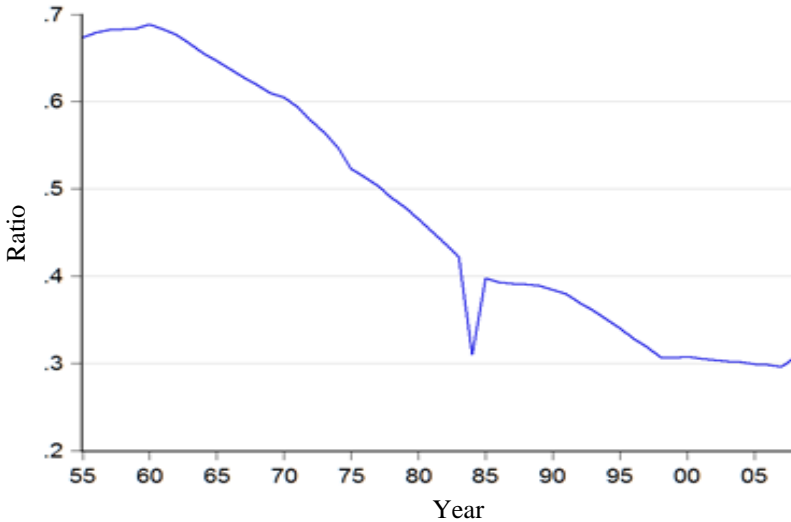
### **1. INTRODUCTION**

Less attention has been given by Islamic economists to the informal economy. The lack of attention means that the Islamic economic system that we want to rebuild is limited to the formal economy only: state and market. Such a limitation creates a myopic approach to solving real-world economic problems. For comprehensive solutions

to real-world economic problems, the informal economy merits more attention.

According to the World Bank (2015), the informal economy is a pervasive and persistent economic feature of most developing economies. In other words, it plays an important role in the developing economy which contributes significantly to employment creation, production, and income generation. It is also estimated that the informal economy generates 40 percent of the Gross National Product (GNP) of low-income nations as compared to only 17 percent of the GNP of high-income ones. This means that in order to be inclusive, Islamic economics can no longer neglect the informal economy.

FIGURE 1  
Malaysia: Size of Informal Economy (Ratio to GDP)



Note. The data are adapted from “The Shadow Economy: Estimates for Malaysia.” (2012). Retrieved from <http://econsmalaysia.blogspot.my/2012/05/shadow-economy-estimates-for-malaysia.html>

In the case of Malaysia, for example, half a century ago, about 40% of the economy was in the informal sector, but the sector has shrunk significantly from the 1980s onwards (Figure 1). In one estimate, the informal economy is approximately 25% larger than the official figure (Hishamh, 2012). However, at present, there is no official data or information on the informal economy in Malaysia and it is estimated using an indirect method. The method used Gross Domestic Product (GDP) and Mixed Income (MI) where the ratio of MI to GDP provides an estimate of the contribution of the informal

economy to GDP. A mixed income refers to income of unincorporated enterprise owner for which the estimated contribution is RM 57,454 million for 2005 (see Table 1).

TABLE 1  
Contribution of Mixed Income to GDP of Malaysia 2000-2005

	2000	2001	2002	2003	2004	2005
	RM Million (Nominal Prices)					
MI	37,212	33,407	43,270	49,943	43,652	57,454
GDP	355,138	349,723	374,802	415,065	488,359	535,945
MI/GDP	10.5%	9.6%	11.5%	10.2%	8.9%	10.7%

Source: Razaman and Ponggot (2009).

A lot of efforts have been made in ensuring that the informal economy contribution could be measured and further be included in estimating the GDP of a country. The main issue in the efforts is that the GDP only captures the formal market activities. But what then constitutes the informal economy? Only with a proper conception of the term can we be able to incorporate some of the informal activities into GDP measurement.

Another point to note is that the acceptability of informal economy varies across countries. The variation in acceptability relies a lot on the countries' conditions and experiences of the causes and effects of the informal economy. Based on certain development conditions, say insufficient job opportunities in the formal market, labor in certain countries might have no choice but to shift and involve with the activities in the informal economy for survival. In some other cases, the existence of the informal economy might harm the development process. It might cause a lower tax collection that could be further translated into a higher investment for development. These countries will then try to reduce the size of the informal economy to the optimal level. Therefore, the potential determinants of employment in the informal economy should be carefully evaluated to provide a strong basis in formulating development policies.

Bearing such awareness in mind, we need to clearly understand the contextual definition of the informal economy. Capturing these aspects is vital for further and accurate analysis of its role in national growth and development. Furthermore, the determinants of the informal economy need to be recognized. If the informal economy appears to burden the nation, then we need to identify its contributing factors. Identifying the determinants also is crucial in order to cover any loophole in the process of economic

formalization. These inquiries are an emerging research area from the conventional economics standpoint. We are of the opinion that, currently, this research area is a level contesting ground for Islamic economics to carve its mark in its modern development. Neglecting the area means we might once again be catching up and borrowing from the conventional economics to shape Islamic economics.

With this awareness in mind, this paper is set out with the following objectives:

1. To identify the nature and development of the informal economy
2. To examine the key determinants and growth of employment in the informal economy
3. To emphasize the potential research areas to be explored in the rethinking and rebuilding process of the Islamic economic system.

The organization of this paper is as follows: Section 2 of the paper deals with the background and development of the informal economy. In Section 3, we review various definitions of the informal economy from the extant literature. We also discuss the links of the sector to selected socioeconomic issues. The discussion then continues to unfold the meaning of informal employment and issues related to it in Section 4. In Section 5, we elaborate the factors of informal employment. In the concluding remarks, we discuss some potential research areas related to the sector for Islamic economists to consider.

## 2. BACKGROUND AND DEVELOPMENT OF THE INFORMAL ECONOMY

Since ancient times, people have been involved in various activities to fulfill the necessities of life. Most of the activities took place at the very micro-unit in the society—the family level. As societies became more organized and civilized, formalization of these activities started, in particular through the introduction of regulations.

Masud (2009) argued that the theory of modernization in development studies in the 1950s and 1960s believed that traditional forms of work would eventually vanish once countries attained sufficient level of economic progress, growth and development. More rules and regulations would be introduced to discipline human activities. At the same time, some people in the society would continuously adjust their economic activity to evade regulations (Masud, 2009). In short, there is a segment of the economy that is

informal and unregulated. Formal control and supervision at all times is impossible. Behaviors and activities in the informal sector, therefore, are unique.

In the early period of modern economics, economists paid little attention to the informal sector. Consideration was only given to the economic activities carried out within the formal economic framework. However, it has been increasingly recognized as an important subject of research in many fields of study such as economics, sociology, and anthropology (Blau and Scott, 1962; Gouldner, 1954). Scholars began to use the term '*informal sector*' since the discovery of the informal activity in the 1970s (Becker, 2004). However, later in the 1990s, scholars have started to use the term '*informal economy*' instead of '*informal sector*' to cover a broader concept of this type of economic activity (Masud, 2009).

The concept was previously applied to cover self-employment activities in small unregistered enterprises before it was broadened to incorporate wage employment in unprotected jobs. Early studies on informal economy found that employment in this economy provides earning opportunities for a large number of people (Merrick, 1976). On the other hand, the inability to formalize some part of the economy would eventually lead to less tax collection by the State and therefore, it could result in reduced investment in national development. All these concerns indicate that the informal economy could become a significant influence on the aspects of poverty, social policy and the labor market. To champion the cause of justice, the rebuilding of Islamic economics should now pay more attention to the informal economy because many of the deprived groups in society fall in this segment of the economy.

### 3. DEFINING THE INFORMAL ECONOMY

Many terms have been used to describe the informal economy such as the underground economy, shadow economy, black economy, hidden economy and more. In the conventional sense, those terms have been associated with a broad range of activities that escape taxation, measurement and regulation (Bernabè, 2002). From an Islamic perspective, those terms are associated with economic activities that may consist of the elements of prohibition (*ḥarām*) or reprehensibility (*makrūh*). To neglect the informal economy just because of these two elements is not the solution. There is more to the term informal economy as we will now elaborate.

According to Bernabè (2002), there is no consensus on what constitutes the ‘*informal*’ sector or economy. Referring to Jie et al. (2011), citing Gyls (2005), the confusion, according to the authors, could lead to huge cognitive losses due to difficulty in “naming” a defined concept that has different contents and understanding. Therefore, it is important to examine the characteristics of the informal economy carefully as an initial approach to avoid an ambiguous understanding of the concept. In Table 2, we provide the various definitions of the concept based on the extant literature.

TABLE 2  
Definitions of Informal Economy/Sector

Author(s)	Informal Economy	Informal Sector
Dallago (1990)	Activities performed within the family or in small communities based on relationships of kinship or friendship.	
Portes and Schaffler (1992)	Illicit production of private goods and services.	
Bagachwa (1995)		Small-scale units that produce and distribute goods and services, consisting of both employed workers and independent self-employed individuals.
Loayza (1996) who follows the work by de Soto (1989)		Set of economic units that do not comply with government imposed taxes and regulations.
Marcelli, Pastor, and Joassart (1999)	Informal economic activity (IEA) is not a single industry sector and is defined instead as all income earning activities not effectively regulated by the state in social environments where similar activities are regulated.	

TABLE 2 (continued)

Schneider (2002)	Any economic activity or source of income that is not subject to government regulation, taxation or observation.
Flórez (2002)	The term informal economy covers a set of varied activities, from unpaid labor to any number of the unregulated salaried job. First, the informal economy is part of the economy at large, which determines its main characteristics and on which it depends. Second, the informal economy is largely defined by activities outside state regulation.
Bernabè (2002)	Referred to street vendors, hawkers and domestic workers in developing countries, tax evasion, drug trafficking and prostitution in western industrialised countries, and petty trade, subsistence farming, the stealing of state property, barter, bribery, corruption, money laundering and organised crime in transition countries.
Chong and Gradstein (2004)	The informal sector should be viewed as part of a voluntary sector.
Albrecht, Navarro, and Vroman (2009)	A sector that is unregulated and hence not directly affected by labor market policies such as severance or payroll taxes.
Schneider, Buehn, and Montenegro (2010)	Market activities that are purposely hidden from the government officers.

TABLE 2 (continued)

Angel-Urdinola and Tanabe (2012)	Collections of firms, workers, and activities that operate outside the legal and regulatory frameworks.
ILO (2014) *2002 Conclusions	<p>All economic activities by workers and economic units that are:</p> <ul style="list-style-type: none"> <li>• not covered or insufficiently covered by formal arrangements.</li> <li>• not included in the law;</li> <li>• operating outside the formal reach of the law;</li> <li>• not covered in practice (although they are operating within the formal reach of the law);</li> <li>• the law is not applied or not enforced;</li> <li>• the law discourages compliance because it is inappropriate, burdensome, or imposes excessive costs.</li> </ul>
World Bank (2015)	Activities and income that are partially or fully outside government regulation, taxation, and observation.

Despite the numerous studies on this topic, different authors have different definitions of the concept, mostly according to the respective objectives of their studies. In general, most of them agreed that the informal economy is the segment of the economy in which the activities are not taxed or regulated by any form of authority. Based on this general definition, notice that not all activities in the informal economy can be considered as *ḥarām* or *makrūh*. In fact, some of the activities are crucial for people to fulfill their necessities. As long as the activities are *sharī‘ah* compliant and legal, any idea to create an inclusive economy should pay attention to this segment of the economy.

Bagachwa (1995) associated the informal characteristic of the sector to include many of the underground economy – either parallel



or black market activities. The underground economy refers to the illegal economic activity. Transactions in the underground economy are illegal either because the good or service being traded is itself illegal or because an otherwise licit transaction does not comply with government reporting requirements. This understanding aligns with that of Feige (1997) who identified four types of underground activities (including “informal”). Jie et al. (2011) then distinguished the four different criteria of an underground economy based on Feige’s idea, namely; (i) illegal, (ii) unreported, (iii) unrecorded, and (iv) informal – refer to Table 3 for elaboration. From the given definitions in the table, activities involving the criteria of illegal, unreported and unrecorded are not *sharī’ah* compliant and must be avoided, according to Islam.

TABLE 3  
Types of Underground Economic Activities

Criteria	Definition	Activities
Illegal Economy Unreported	Totality of the revenues generated by those economic activities that violate the legal status of legitimate forms of trade.	Illegal activities such as illegal drug dealing, black market currency, money laundering, unlicensed money lending, illegal gambling, prostitution and pornography.
Unreported Economy	Totality of economic activities that escape or avoid fiscal rules as they are defined in fiscal codes.	Unreported revenue either from legal sources or illegal sources.
Unrecorded Economy	Activities that avoid institutional conventions that define the necessary requirements for the report to governmental agencies for statistics.	
Informal Economy	Economic activities that avoid costs and excluded from the rights and benefits that come along with leasing, work contracts, loan and social security.	Revenue generated by economic agents that operate informally.

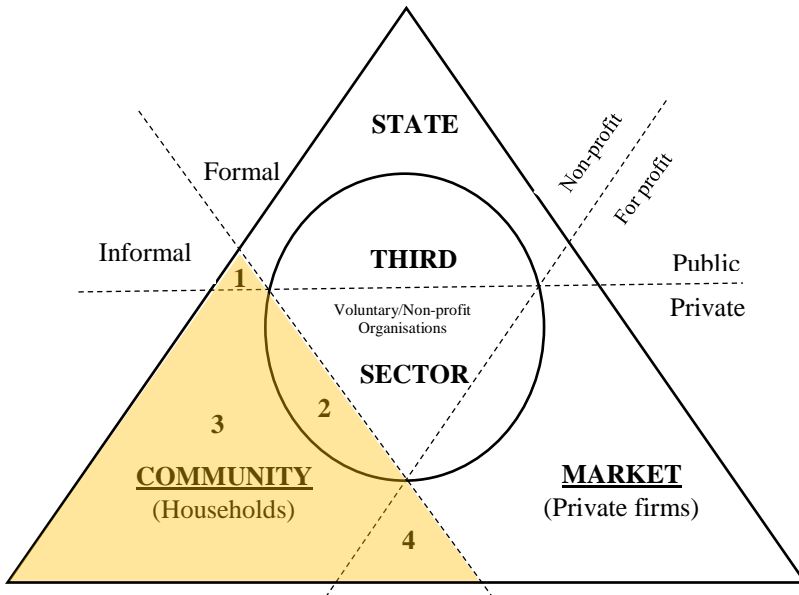
Source: Feige (1997); Radulescu, Propescu and Matei (2010).

In the pursuit to understand the contextual scope of the informal economy, we acknowledge its various dimensions.

Underground activities, for example, can also be associated with the informal economy. The activities normally have no official accounts, are not registered and involve few workers. Estimating these activities is not easy because they are conducted in secrecy. Another dimension to note here is that the informal economy can also be categorized into for-profit or non-profit. The categorization adds to the complexity in contextualizing activities in the informal economy.

In order to understand the dimensions of the informal economy, we adopt Defourney and Pestoff's (2008) model of the Third Sector. The aim here is to unfold the characteristics of the informal economy. From Figure 2, in general, the entire economy can be divided into formal and informal activities (see the diagonal dashed line). However, this study focuses only on the informal part as portrayed by the shaded area in Figure 2. Economic activities are considered to be informal in the sense that they are mostly unregistered, unrecorded in official statistics and participants have little or no access to organized markets, to credit institutions, to formal education and training or to many public services (ILO, 1991).

**FIGURE 2**  
Informal Economy in the Mainstream Economy



Source: Defourney and Pestoff (2008).

As mentioned earlier, activities in the informal economy can be divided into for-profit and non-profit objectives. This division can go in line with the taxonomy of types of underground economic activities introduced by Mirus and Smith (1997). Table 4 gives an overview of different kinds of informal economic activity, ranging from illegal activities to legal activities with deliberately undeclared sources of income (tax evasion), to legal activities with transactions that have no legal tax obligation (tax avoidance).

TABLE 4  
Taxonomy of the Types of Underground Economic Activities

Types of Activity	Monetary Transactions		Non-Monetary Transactions	
	Tax Evasion	Tax Avoidance	Tax Evasion	Tax Avoidance
Illegal Activities	Trade with stolen goods; drug dealing and manufacturing, prostitution, gambling, smuggling fraud etc. through counterfeiting, computer system hacking; trading stolen information; identify theft and spamming.		Barter of drugs, stolen goods, smuggling, etc. Produce or growing drugs for own use.	
Legal Activities	Unreported income from self-employment; Wages, salaries and assets from unreported work related to legal services and goods.	Employee discounts, fringe benefits.	Barter of legal services and goods.	All do-it-yourself work and neighbor help.

Source: Mirus and Smith (1997) with additional remarks by Schneider and Enste (2000), Edwards and Flaim (2008).

Again, referring to Figure 2, areas 1, 2 and 3 are more to the non-monetary transactions. It can also be either legal or illegal activity. Correspondingly, there are voluntary activities undertaken informally shown as areas 2 and 3. Here is where charitable giving is the common way of individuals to participate in voluntary acts such as by giving donations (*sadaqah*). Individuals also involve themselves

in voluntary non-monetary acts such as devoting certain hours doing voluntary work at an orphanage, social community watch, providing aid to the homeless or via *manṭah* and *waqf* (Mohd Arshad and Mohamed Haneef, 2016). These activities are among the distributive schemes in the Islamic economic system. A recognition of these activities (e.g., the need for standard accounting practices) can further enhance the transparency of activities ordained by the teaching of Islam.

Nevertheless, many extant studies have focused on area 4, in Figure 2, as it is associated with monetary transactions and would eventually impact on a country's GDP. This focus can either be positive or negative. For instance, home-tutoring can be categorized in this section because eventually, it provides income to the tutor—positive. The same also applies to the black market activity (i.e., stolen art or pirated software) where it constitutes major contributions to revenue in some countries—negative. Therefore, this framework provides easier understanding on the concept of informality in an economy and helps in guiding to its better recognition and measurement.

In the case of Malaysia, as mentioned in the Country Report for Malaysia; Regional Course on Statistics on Informality (Abd Aziz and Mohd Ali Khan, 2015), the concept of informality is adapted specifically through the 15th and 17th International Conference of Labour Statistics (ICLS). An enterprise is classified as belonging to the informal sector if it fulfills the following criteria:

- i. Not registered with the Companies Commission of Malaysia;
- ii. All or at least one of the products are for sale or barter transactions;
- iii. Ten or fewer employees and their employment are not subjected to labor legislation, social security regulations and collective agreement; and
- iv. Non-agriculture sector.

This definition is more to the enterprise-based definition. However, it is useful for analytical purposes of different targets for policy-making.

#### 4. DEFINITION OF INFORMAL EMPLOYMENT

The informal economy has many important implications. In this section, we discuss further its implications on the social and labor

market activities due to their relevance in ensuring sustainable socioeconomic development. We reiterate our call for Islamic economists again not to neglect the informal economy for one simple fact; that is, the informal economy provides diverse sources of income and employment, especially in countries where formal employment opportunities are limited and social security is almost absent (Bernabè, 2002).

In the labor market, employees are claimed to be protected by labor legislation. However, in practice, most of the time they are not in a position to claim their rights due to the deficiency of the mechanism to enforce existing regulations (Husmanns, 2004). In this case, employees in the informal sector are more vulnerable as compared to the 'less-privileged formal employment'. As far as Islamic economics is concerned, discussions on labor issues from an Islamic perspective are limited. More serious than that is when issues related to workers' rights are unattended to, particularly in the Muslim countries. The scenario perhaps is worst in the informal sector of the economy.

In Table 5, we provide some definitions of informal employment based on the extant literature. Informal employment has often been identified using an enterprise-based definition (Husmanns, 2004). Mostly, the informality of the employment or enterprise is defined based on certain characteristics such as:

- i. Inability to maintain official accounts;
- ii. Not registered with a government agency; and
- iii. A small number of workers.

The International Labour Organization (ILO) through the 15th ICLS, recognized that employment in the informal sector as comprising "all jobs in informal sector enterprises, or all persons who, during a given reference period, were employed in at least one informal sector enterprise, irrespective of their status in employment and whether it was their main or a secondary job". Later, this concept and definition was expanded as a result of an intensive discussion in the 17th ICLS (Heintz and Posel, 2008). The discussion suggested inclusion of certain types of informal employment which previously had been disregarded.

The new concept and definition seeks to include not only enterprises that are not legally regulated but also employment relationships that are not legally regulated or protected (Chen, 2007). The new definition of informal employment is given as "the total

number of informal jobs, whether carried out in the formal sector enterprises, informal sector enterprises, or households, during a given reference period.”

TABLE 5  
Definitions of Informal Employment

Author	Informal Employment
Marcelli, Pastor, and Joassart (1999)	Small-scale entrepreneurs (e.g., street vendors, transport operators, craft producers) who skirt the legal and bureaucratic obstacles preventing them from earning a decent standard of living in a market economy.
Kucera and Galli (2003)	Firms with fewer than five workers and also non-professional self-employment.
Husmanns (2004)	Includes all jobs in informal sector enterprises or all persons who, during a given reference period, were employed in at least one informal sector enterprise, irrespective of their status in employment and whether it was their main or a secondary job.
Davies and Thurlow (2010)	Informal households are those earning any income from the informal sector, including incomes from workers that are informally employed in the formal sector.
Kantor (2009)	Having no or lack in contract-based wage and non-wage benefits and no long-term job security.
Angel-Urdinola and Tanabe (2012)	The share of overall employment is not contributing to social security.
Torns et al. (2013)	Set of jobs or tasks that have one or more of the following features: unregulated, undeclared, unskilled and low-paid.
ILO (2011)	The sum of employment in the informal sector and informal employment found outside the informal sector.
Loureir, Araujo, and de Souza (2013)	Informality as tax avoidance where firms and workers in the informal sector avoid tax payments but suffer other constraints such as limited access to legal protection, hedge and credit.
Amin and Islam (2015)	Informal firms – Informality as lack of registration.

As mentioned in the Country Report for Malaysia (Abd Aziz and Mohd Ali Khan, 2015), informal employment is defined based on three categories, which are:

- i. Informal employment in the formal sectors that fulfill the following criteria:
  - a. Employed in a registered or unregistered enterprise with ten or more employees; and
  - b. Employees who do not have explicit and written contract as well as not subjected to labor legislation, social security regulations and collective agreement.
- ii. Informal employment in the informal sectors as follows:
  - a. Own-account workers in their own informal enterprise;
  - b. Employers in their own formal enterprise;
  - c. Unpaid family workers; and
  - d. Employees who do not have explicit and written contract as well as not subjected to labor legislation, social security regulations and collective agreement.
- iii. Informal employment among households (i.e., own-account workers and paid domestic workers)

This specific concept of informal employment is significant in providing technical guidance for measuring informality in a country. For measuring the quantum of employment, what is required is not merely the size of the working population, in terms of headcount, but a measure of total labor input going into the production activities in the economy. For example, given the multiple economic activities carried out by a large proportion of the working population in Malaysia, the count of all jobs pursued by each, either in principal or subsidiary capacity, is considered to be a more representative measure of labor input (Kamaruddin and Ali, 2006).

After the definitions and scopes of the informal employment have been identified, the next crucial task is to formulate proper policies to protect the rights of those in the sector. A value-loaded and value-driven Islamic economics, therefore, is expected to champion this cause.

## 5. DETERMINANTS OF INFORMAL EMPLOYMENT

If Islamic economics wants to be inclusive, it cannot neglect the informal sector. Islamic economics must address various issues and problems faced by those working in the informal sector in order to be inclusive in its approach. To understand the issues and problems, the

discussion now moves on to the determinants of informal employment.

Over the past decades, the informal economy has been a growing concern for researchers and international policy makers to study its possible determinants. Krakowski (2005) stated that information on the informal economy size and its potential causes is of considerable importance to policy makers. In the literature, there are different understandings in looking into the reasons behind informal labor market existence. Some have focused on the role of government, while some stressed on the micro level which is the decision of labor, whether or not to enter the informal economy.

A growing literature has discussed the determinants of the informal economy. Government policies and efficiency are often being highlighted as the main determinant. It can be presented by the intensity of regulations, taxes and the cost of establishing a business, and so forth (see Table 6). In this case, most of the studies agreed that tax burden (for example, the imposition of payroll tax) seems to be the most important influence on the informal economy. In other words, when the tax burden increases, the informal economy tends to grow as it reduces the number of formal-sector workers (Albrecht, Navarro, and Vroman, 2009; Loayza, 1996; Schneider and Enste, 2000; Schneider and Klinglmaier, 2004; Salisu, 2001; Ihrig and Moe, 2001).

Also, Binay (2015) agreed that the increase in tax burden and social security contributions could lead to lower income for employers which then create an incentive for employers to work in the informal economy where they can benefit from lower wage rates. This also means those who are exempted from tax are more likely to join the informal economy because tax affects labor-leisure choices of an economic agent. Self-employment would not be motivated by the desire to evade taxes, but rather an active role of the government may enhance it (Pietrobelli, Rabellotti, and Aquilina, 2004). However, extending the informal economy will somehow reduce total tax revenue by shrinking the tax base, which in turn creates a need for higher tax rates.

A study by Mara and Narazani (2011) contributes an interesting finding where they employed flat tax as their variable to see its impact on informal employment. They found that flat tax has not contributed to reducing labor informality; instead, the increases in regular wages have played an important role in convincing individuals to move to the regular market. Controls and audits are said to be more efficient than fines in inducing people to switch from the informal to the formal labor market.



**TABLE 6**  
**Determinants of Informal Employment:**  
**Government Policies and Efficiency**

Literature	Country	Variables
Loayza (1996)	Latin American countries	Tax burden Strength and efficiency of government institutions
Schneider and Enste (2000)	<ul style="list-style-type: none"> <li>• Developing countries</li> <li>• Transition countries</li> <li>• OECD countries</li> </ul>	The burden of tax and social security contributions Intensity of regulation Social transfers Overregulation and labor costs in the official labor market <ul style="list-style-type: none"> <li>• Public sector services</li> </ul>
Salisu (2001)	Nigeria	Tax burden Unnecessary regulatory regimes Lack of institutional capacity Weak governance
Ihrig and Moe (2001)	Sri Lanka	Tax rates Enforcement policies
Schneider and Klinglmair (2004)	110 <ul style="list-style-type: none"> <li>• Developing countries</li> <li>• Transition countries</li> <li>• OECD countries</li> </ul>	Tax and social security contribution burdens Intensity of regulations Public sector services
Albrecht, Navarro and Vroman (2009)	Theoretical	Labour market policy Payroll taxes Severance Taxes
Mara and Narazani (2011)	Albania	Flat tax
Williams (2015)	41 less developed countries	Corruption Higher taxes and state interference Inadequate state intervention to protect workers from poverty

However, in the case of less developed countries, Williams (2015) found that lower level of informal employment was associated with the development and state intervention in the form of higher tax rates and social transfers to protect workers from poverty. Williams (2014, 2015) pointed out that the finding goes in line with the new

“neo-modernization” explanation in clarifying the cross-national variations in the informal employment of the developed world. Different countries, he argued, would have different policy treatments to reduce the size of informal employment.

According to Krakowski (2005), regional regressions reveal that different aspects of governance dominate the relationship between government efficiency and the size of the informal economy in different regions. Bureaucracy with intense regulations, such as high entry costs, strict labor regulations, long and complicated procedures, substantially discourage movement toward formality (Elveren, 2015). In recent years, China’s labor market, for example, is steadily becoming formalized and the percentage of informal employment is expected to drop due to its new regulations on the labor market in order to protect legal rights and interests of workers (Xue, Gao and Guo, 2014).

The Ministry of Human Resource Malaysia (MOHR), in collaboration with the Department of Statistics Malaysia (DOSM), found four factors caused the existence of informal economy in Malaysia, which are:

- i. Lack of awareness and knowledge of the rules, regulations and benefits of registering businesses;
- ii. Business factors such as the high cost of registration which is not cost-effective to the entrepreneurs;
- iii. Regulatory issues such as the intention to evade tax, bureaucratic challenges in the registration procedures and lack of enforcement and actions by the authority; and
- iv. Environmental barriers such as the remote location of their businesses as well as owned and operated by non-citizens.

Most of these factors are mainly related to the role of government in order to ensure the legalization and formalization of informal businesses. Perhaps, having a more business-friendly environment would help to boost the economy by fixing the behavior of labor market participants.

Furthermore, poverty also drives many people into informal employment as it is the only way they can survive without access to unemployment benefits. Poverty coerces people into self-employment or to accept any job so that they can earn income. ILO reported that jobs in the informal economy often mean poor employment conditions and association with increasing poverty. Williams (2014) found that the greater the percentage of the population at risk of poverty in a

country, the larger is the informal economy. However, people with low income frequently cannot earn enough in the informal economy to escape poverty. Therefore, it creates a complex interaction between poverty and the informal economy. Again, this point should raise further interest among Islamic economists to understand better the relationship between poverty and the informal economy. Table 7 gives the literature on gender determinant of informal employment.

TABLE 7  
Determinants of Informal Employment: Gender

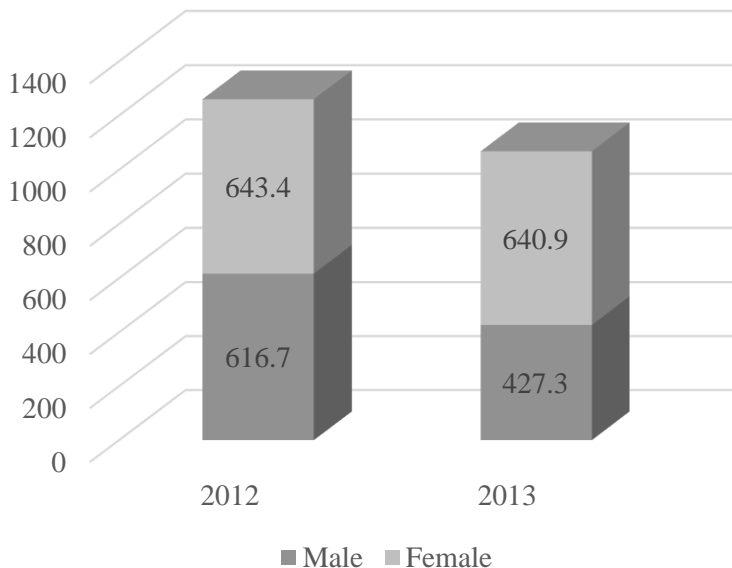
Literature	Country	Findings
Tansel (2000)	Turkey	For uncovered wage earners, men's wages are near parity with those of women. The results suggest segmentation for men along the formal and informal lines and substantial discrimination against women in the covered private sector.
Wahba (2009)	Egypt	Mobility from informal to semi-formal/formal employment is highly segmented along gender in Egypt.
Rodin et al. (2012)	Mexico	Informal employment was not a choice for many women who entered the informal labor market due to human capital constraints and family responsibilities.
Elveren (2015)	Turkey	Relatively minor effect of women's employment and thereby points to the importance of increasing women's labor force participation.
Doğrul (2012)	Turkey	Females have a higher chance than men to work in the public and informal sectors as opposed to unemployment particularly the informal sector.
Amuedo-Dorantes (2004)	Chile	Household poverty increases the likelihood of wage and salary work in the informal sector by approximately 3% among male household heads and by 6% among female household heads.

Most of the existing studies discuss the factors of the informal economy from the macro-perspective (e.g., by looking into its relationship with government policies and regulations). Nevertheless, it is also crucial to better understand individual characteristics on which types of employment these people would prefer and the reasons behind them. Micro-sociological and psychological approaches can provide additional insights into the decision making process of

individuals choosing to work informally (Schneider and Enste, 2000). Some demographic characteristics such as gender and education are crucial in explaining participation in the informal economy (Wedderburn, Chiang and Rhodd, 2012)—refer to Tables 9 and 10.

The issue of gender in informal employment has attracted much public attention (see Table 7). The literature presents mixed findings on gender and employment. The informal employment by sector among developing countries shows that the share of women in informal employment in manufacturing activities is usually higher than that of men (ILO, 2011). Wedderburn, Chiang and Rhodd (2016) cited de la Roca et al. (2006) who pointed out that the majority of individual workers in the informal sector are women, comprising 57% of self-employed.

FIGURE 3  
Employment in the Informal Sector by Gender in Malaysia 2012-2013 ('000)



Source: Country Report for Malaysia Regional Course on Statistics on Informality: Informal Economy, Work and Employment (Abd Aziz and Mohd Ali Khan, 2015).

In the case of Malaysia, however, the finding is parallel with Tansel (2000). Department of Statistics Malaysia recently showed that female employment in the informal economy is almost equal to male's percentage which is 49.9% in 2013, a significance increase from

40.9% in 2012 (Figure 3). These statistics are not surprising in the case of Malaysia – a country with open labor market participation. The main reason for women entering the informal economy might be the desire for independence and to earn a higher income and not mainly because of deficiency of jobs in the formal sector. Women are more likely than men to work in jobs that offer flexible working arrangements (such as part-time or informal jobs) so that they can combine work with household responsibilities (World Bank, 2012).

TABLE 8  
Determinants of Informal Employment: Education

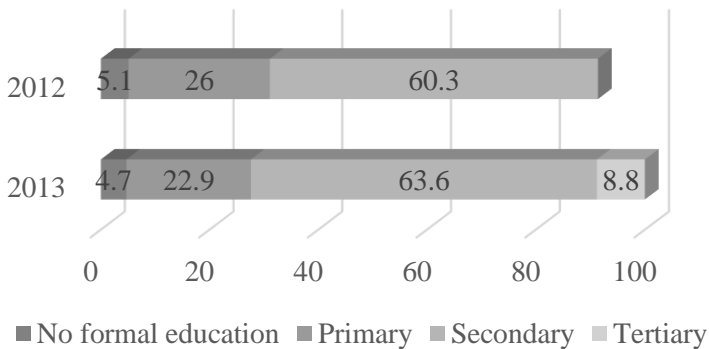
Literature	Country	Findings
Portes, Blitzer, and Curtis (1986)	Uruguay	Household heads with a university education represent a small minority of the sample but, those who have attained this level receive significantly higher remuneration regardless of their labor market position.
Pietrobelli, Rabelotti, and Aquilina (2004)	<ul style="list-style-type: none"> <li>• 64 developing countries</li> <li>• 19 developed countries</li> </ul>	No definitive evidence has been obtained on the role played by education although the relation seems to be positive for primary and negative for secondary education.
Gong and van Soest (2002)	Mexico	Wage differentials between formal and informal sector are typically small for the lower educated but increase strongly with higher education level.
Wahba (2009)	Egypt	The mobility from informal to semi-formal/formal employment is highly segmented along education.
Angel-Urdinola and Tanabe (2012)	Egypt	A worker in the informal sector in Egypt who has completed five years of education (equivalent to primary education) earns similar wage rates to those of a worker in the informal sector who has attained 12 to 14 years of education (equivalent to complete secondary and some post-secondary education).
Doğrul (2012)	Turkey	Education appears to have a negative impact on the informal sector employment.

Apart from gender, education is another important factor that can influence the employment level in the formal or informal economy. In Table 8, selected literature on education and informal employment are presented.

In general, people with secondary education level and below are the main workforce in the informal economy. Involvement in the informal sector is low for persons with a tertiary education. Figure 4 depicts employment in the informal economy by educational attainment in Malaysia where the data supports the above observation. The highest percentage is constituted by the secondary level of education followed by primary level; one possible explanation is that the informal sector employment mainly requires workers with basic skills and knowledge rather than workers with high skills and knowledge (Doğrul 2012). Therefore, those with secondary education level and below provide the pool of workers needed by the informal economy.

In the case of Egypt, Wahba (2009) stated that informal employment constitutes an important entry point for highly educated male workers. This scenario explains the role of the informal sector as a temporary employment avenue for new entrants waiting for formal jobs. Higher rates of unemployment also can act as a growing factor in the informal sector, especially in developing countries.

FIGURE 4  
Employment in the Informal Sector by Educational Attainment,  
2012-2013 (%) (Malaysia)



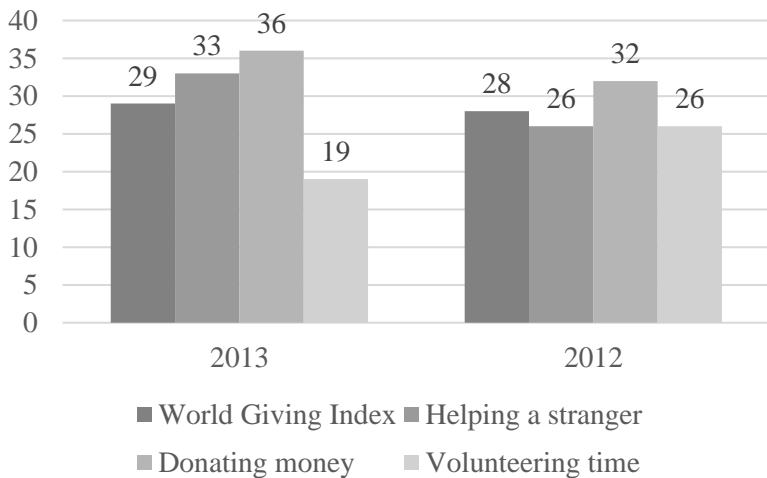
Source: Country Report for Malaysia Regional Course on Statistics on Informality: Informal Economy, Work and Employment (Abd Aziz and Mohd Ali Khan, 2015).

Following the characteristics of informal economy as explained in Section 3 earlier, Figure 2 shows that there is some part of the informal economy involved in the third sector. Let us assume that this part (area 2 in Figure 2) is being filled by the level of religiosity. Religiosity is assumed to be positively related to charitable giving and volunteerism. Individuals with higher levels of religiosity are more likely to engage in both organized volunteering and informal acts of compassion and, on average, give charitable donations more frequently and at higher levels.

Figure 5 shows that giving behavior in Malaysia had increased from 2012 to 2013 as the overall index was rising (except in volunteering time). By showing this result, somehow, it indicates that the involvement in the informal, third sector activity is influenced by the level of religiosity in the case of Malaysia.

From the preceding discussion, all these aspects are said to be the contributing factors to the existence of informal section in an economy. It is significant to realize the main causes of informal employment which might accelerate or reduce the expansion of the informal economy in such country.

FIGURE 5  
World Giving Index Score, with Giving Behaviour Participation:  
Malaysia (%)



Source: World Giving Index 2013 (Charities Aid Foundation, 2013).

## 6. CONCLUSION

Efforts to understand and evaluate the roles of the informal economy start with a clear definition of it. The conceptual understanding is a continuous and dynamic process because the informal economy evolves with time and situation. The idea of informal economy varies according to countries, which takes into account the prevailing conditions and experience (i.e., economic, political and cultural aspects). The difference, for example, is substantial between the developed and developing countries. Its influence on the economy can be either positive or negative.

From the discussion, factors such as government policies and efficiency, poverty issues, gender inequality, education and religiosity are the key determinants of informal employment. Some people enter informal employment not by choice, but because of dire necessities (particularly those in developing countries). The informal economy, in this case, is crucial to these people. Islamic economists, therefore, should be more sensitive to the issues in the informal economy in their efforts to rebuild the Islamic economic system.

Policymakers also need to consider the conceptual and policy impediments arising from this considerable diversity of situations in the informal economy (ILO, 2014). In the case of Malaysia, for example, the government is making continuous efforts in minimizing the size of the informal economy by strengthening the enforcement activities and increasing people's awareness and knowledge on the rules, regulations and benefits of having formal businesses. Facilities on the business licences' approval might also help to hasten the business formalization process.

There is also need to establish a comprehensive dataset about the informal economy. With the availability of more quality data, we hope to achieve better understanding of the informal economy. Then, a comprehensive study on the potential consequences of the growing or shrinking of the informal economy should be conducted by taking many different factors into considerations. Profound understanding of the informal economy effects on socioeconomic wellbeing of a country could help us to lay strong foundations to formulate policies beneficial to economic growth and development. Again, we call upon the Islamic economists to incorporate this subject into the rethinking process to rebuild the Islamic economic system.



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