

The Informal Sector, The Missing Middle, And Implications for Development Policy

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Abstract

The informal sector plays a pivotal role in shaping labor markets and economic structures, particularly in developing and emerging economies. Despite accounting for a significant portion of the workforce, especially in emerging economies, it remains underexplored in policy discourse. It is often treated as a monolith, with recommendations tending to favor formalization over recognizing its complexity as a multifaceted phenomenon. Characterized by the absence of government regulation and oversight, the informal sector demands greater analytical attention. A deeper understanding of its diverse forms and drivers is essential for crafting development policies that are both effective and context-sensitive.

This paper examines the informal sector's complexities, causes, consequences, and recommendations for formalization. It critiques insufficient attention to the sector's diversity and the different impacts of formalization.

Through a case study of India, this paper explores the diverse nature of India's informal sector divided into different elements: agriculture, manufacturing, informal urban housing, and identifies examples of informal economies that have their roots in culture. The case study highlights the diversity in informal economies.

Keywords: Informal sector; Developing Economies; India; Missing Middle; Culture

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1. The Context

The informal sector – also referred to sometimes as the “informal economy”, “unorganized sector”, “informal employment” among others – is a global phenomenon (International Labour Organization, 2024). The International Labor Organization estimates that over 60 per cent of the world's employed population, i.e. nearly 2 billion people, earn their livelihoods in the informal sector (International Labour Office, 2018, p. V; International Labour Organization, 2024). It estimates that over 90% of micro and small enterprises (MSEs) worldwide are involved in the informal sector (International Labour Office, 2018, p. V; International Labour Organization, 2024). However, the informal sector is typically larger in emerging and developing economies than in developed economies (International Labour Office, 2018, p. V). In developed economies the informal sector accounts for about one-fifth of the GDP and 16 percent of employment, while in many emerging market and developing economies, the informal sector constitutes over 70 percent of total employment and roughly one-third of the GDP (The Long Shadow of Informality: Challenges and Policies, 2022).

What is the informal sector? The informal sector is typically defined as comprising economic activities that are not “regulated, controlled, supported, audited and taxed by the government.”(Larsson & Svensson, 2018, p. 535)

The informal sector can also be described as comprising those activities that are not covered by formal arrangements. The World Bank describes the informal sector as “operat[ing] outside the line of sight of governments” (The Long Shadow of Informality: Challenges and Policies, 2022, p. Foreword). Erika Kraemer-Mbula explains the activities performed in the informal sector as follows (Torkington, 2024):

We are referring to entrepreneurs that are providing legitimate products and services but that do not comply with some of the regulatory requirements. Perhaps they don't have a permit. They don't have registration of the business. That is what we talk about when we talk about the informal economy.

The diversity of activities that could potentially fall within the informal sector is vast. When the informal sector is mentioned, the images that are typically invoked are of unregistered ride shares, street vendors, domestic workers, and handicraft makers. With advances in information technology, a plethora of different types of activities have also come within the fold of the informal sector, and increasingly “freelancers and [] high-skilled individuals are also engaged in informal activities providing all sorts of consulting, research and creative activities ” (Torkington, 2024). The International Labor Organization describes the informal economy as including “all informal productive activities of persons and economic units” (International Labour Organization, n.d.-b). This dynamism of the informal sector is reflected in the observation of Larsson and Svensson that “the informal economy usefully reinvents itself and emerges in new and unexpected ways and places” (Larsson & Svensson, 2018, p. 534).

Against the background of this diversity, a key question that the informal sector literature explores is how the legal and regulatory regimes of a country can regulate the informal sector and bring it into the fold of the formal sector. Most recommendations by international organizations and experts to address shortcomings of the informal sector encourage the formalization of the informal sector (Cooter & Schäfer, 2012; DeSoto, 1989; all discussed in Prado & Trebilcock, 2021a, pp. 164–165; World Bank, n.d.). However, the literature has paid insufficient attention to the diversity of the nature and causes of the informal sector and the impact of formalization of the informal sector even within a given country, region or sector.

Should the reaction to every activity occurring within the informal sector be to formalize it, or are there other measures that should be explored bearing in mind the diversity of this sector? To explore this question, this paper undertakes a case study of India to explore the nuances of the informal sector, i.e. the circumstances in which certain informal activities may arise and the diversity of the impact of formalization of activities, in order to illustrate the diversity that exists not only across countries (which is widely recognized by scholars) but even within a particular country, region or sector, in order to determine the policy and regulatory interventions that may be appropriate in addressing activities in the informal sector.

This paper begins by describing the consequences of the informal sector (Section 2), the causes that are typically identified for the existence of the informal sector (Section 3), and recommendations that are commonly proposed to address the negative consequences of the informal sector (Section 4). Section 5 discusses the concept of the ‘missing middle’ and Section 6 highlights the issue that barriers in developing countries hinder the formalization of businesses, forcing many to remain informal and limiting their growth potential. Section 7 provides a case study of India focusing on various activities in the informal sector: the agricultural sector, the manufacturing sector, and the informal urban housing sector. The section also provides examples of informal economies that have their roots in culture. Section 8 concludes that informal economies must be understood within their specific contexts, with attention to the unique nuances that shape them. Before determining whether formalization is necessary—and if so, in what form—it is essential to conduct a thorough, context-driven analysis. In some instances, this may call for a more hands-off approach by the government, while in other cases a more proactive governmental role may be appropriate.

2. Consequences of the informal sector

Much scholarly and official discussions of the impact of the informal sector highlights the negative consequences of the informal sector, which are especially accentuated in developing countries. But scholars have also argued that the informal sector has in some cases made positive contributions to the formal sector in both developed and developing countries. This section begins by identifying the commonly identified negative impacts of the informal sector on individuals working in the informal sector and at the broader social level. The section then discusses some of its positive contributions especially in developing countries.

At the individual level, one of the primary concerns with the informal sector is of a socio-economic nature. Although the informal sector creates employment and generates income for participants, the individuals working in the informal sector do not have the same social safeguards that would typically be provided to them in the formal sector. They may not receive minimum wages, health insurance, maternity leave, sick leave, safe working conditions or job security. They would typically not receive written contracts and hence not receive contractual protections. These concerns are accentuated due to the fact that many of the individuals working in the informal sector come from the most vulnerable sectors of society, comprising predominantly women, ethnic or religious minorities and the young and low-skilled (The Long Shadow of Informality: Challenges and Policies, 2022).

Those involved in the informal sector, including small and medium sized enterprises, also have limited access to formal financing, which becomes a major constraint on doing business. The informal financing that stakeholders may have access to is typically more risky and costly when compared to formal financing (Alibhai et al., 2017, p. 32). Facing a higher cost of capital, they are unable to expand to minimum efficient scale (de Paula & Scheinkman, 2007).

At the broader social level, one of the key concerns with the informal sector is tax evasion. Most businesses transacted do not contribute to taxation and as a result government's ability to raise revenue is constrained. This phenomenon directly contributes to lower public expenditures, such as healthcare and education (The Long Shadow of Informality: Challenges and Policies, 2022). The scale of the informal sector also undermines a country's effort to achieve the UN's Sustainable Development Goals. Matsongoni and Mutambara describe this phenomenon as follows (The Long Shadow of Informality: Challenges and Policies, 2022).

“Countries with larger informal sectors have lower per capita incomes, greater poverty, less financial development, and weaker growth in output, investment, and productivity. Gross domestic product (GDP) per capita in countries with above-average informality tends to be just one quarter to one-third the GDP per capita of countries with below-average informality.”

The impact of the informal sector often differs markedly between developing countries and developed countries (Gerxhani, 2004, p. 268). In developed countries the informal sector typically makes a positive contribution to the formal sector, while in developing countries the informal sector has a negative influence on the formal sector. To illustrate, Schneider in a study of the informal sector in Austria and Germany concluded that “at least two-thirds of the income earned in the shadow economy is immediately spent in the official economy resulting in a considerable (positive) stimulating effect on the official economy” (Schneider & Enste, 2000, p. 4). Schneider added that “[the] two-thirds of the value added produced in the shadow economy would not be produced in the official economy if the shadow economy did not exist” (Schneider & Enste, 2000, p. 4). In contrast, de Paula & Scheinkman in a study focusing on the informal sector in Brazil concluded that when one level of the production stage involves an informal firm, it increases the probability of tax avoidance in upstream and downstream firms (de Paula & Scheinkman, 2007).

However, even in developing countries the informal sector has the potential to make a positive contribution to the formal sector (for e.g. see Termeer et al., 2024). The relationship between the formal and informal sectors has the potential to reduce transaction costs in the provision of public goods (Ostrom, 1996). These may arise due to efficiencies existing in informal networks that may take a variety of forms. To illustrate, where the State is unable to provide water services, the informal sector has often stepped in to provide water services to marginalized communities (Shah, 2007). In this respect the informal sector is providing a vital service to the marginalized. However, since it is performing a function that should be provided by the State, the State's legitimacy is diminished as a consequence.

3. Causes for the existence of the informal sector

The existence of the informal sector is attributable to a large range of reasons. According to the International Labor Organization: “Drivers of informality are multiple and transcend the world of work” (International Labour Organization, 2021, p. 13). One of the most commonly cited reasons is that individuals are compelled to enter the informal sector from a lack of choice, as they are unable to find opportunities in the formal sector. The World Economic Forum estimated that since 2020, the economic recovery post the COVID-19 pandemic has been significantly enhanced by the informal sector, where “out of every five jobs created for women, four are within the informal economy; for men the ratio is two out of every three jobs” (World Economic Forum, 2023, p. 7).

Scholarly and official commentary on the informal sector is largely silent on the possibility that some of the people may prefer to work in the informal sector on account of cultural reasons. For example, in India, in some traditional households women are discouraged from working in the formal sector. While efforts need to be made in improving women's rights so that they can realize their full potential, in the interim their only option may be to work in the informal sector such as making and selling items from their homes, providing them additional income and giving them enhanced financial freedom and independence. In this scenario, the issue of lack of choice is a cultural phenomenon and not mainly a result of legal or regulatory restrictions or requirements constraining entry into the formal sector.

The informal sector is also fostered in situations when there is a need to address inadequacy in regulatory frameworks, fill institutional gaps, or when the domestic particularities are not taken into consideration and addressed (International Labour Organization, 2021; Meagher, 2013; North, 1991; Turnbull, 2022). To illustrate, an example from Nigeria demonstrates the role that the informal sector can play in the provision of public goods that is typically the State's domain, filling an institutional gap addressing local needs (Ostrom, 1996, p. 1076):

In all of the villages we visited, informal associations of villagers were actively engaged in community projects such as the maintenance of a road, the repair of a school building, and/or the construction of a community center. In many cases, the successful "sons and daughters" of the village returned each year to participate in general planning of improvements that could be made and they sent funds to purchase supplies that were needed to undertake the project. Some projects would take many years to complete because of limited resources, but all of the villagers were proud to tell us of the projects they had undertaken. In all of the villages, therefore, it was possible to mobilize citizen effort for community affairs and the coproduction of goods and services.

The game theoretic literature and the law and social norms literature, describe how in the context of property regimes "spontaneous cooperation or informal norms can often substitute for a formal property regime maintained by the state" (Ostrom, 2015; For a discussion see Prado & Trebilcock, 2021b).

4. Recommendations for addressing the informal sector

Recommendations for addressing the informal sector typically focus on formalizing the sector. International organizations have strongly advocated the formalization of the informal sector and have proposed steps that can help foster the transition of the informal economy into the formal economy. Organizations such as the ILO and the UN have taken initiatives to encourage this transition: The ILO through its *Transition from the Informal to the Formal Economy Recommendation (No. 204)* (For e.g. see International Labour Organization, 2015) and the UN through the United Nations 2030 Agenda for Sustainable Development, among which the SDG 8 specifically focuses on increasing formalization of the informal economy. The ILO concludes that initiatives that have been successful aim to formalize the informal economy by (i) facilitating the transition of workers from the informal sector to the formal sector; (ii) promoting the creation of jobs in the formal sector; and (iii) preventing the informalization of formal jobs (International Labour Organization, 2024). The recommendations that are commonly made seek to improve governance, such as developing a supportive legal and regulatory framework, and favorable financial infrastructure (Matsongoni & Mutambara, 2018). International organizations and experts stress that the causes for the existence of the informal sector stem from underdevelopment, so that efforts to address their concerns must be considered in this broader context and not in isolation (La Porta & Shleifer, 2014; The Long Shadow of Informality: Challenges and Policies, 2022).

Scholars and international organizations caution against a narrow approach to proposing formalization. Powell argues, over-regulating marginal sweatshops may lead to job losses, forcing workers into even more oppressive informal employment (Powell, 2025). This critique highlights the potential harm of well-intentioned but poorly calibrated formalization efforts. The IMF has argued that efforts to formalize the informal sector should adopt a balanced approach, for despite the negative impacts of the informal sector (discussed in Section 2 above) the livelihood earned from the informal sector may be the only source of income for many individuals (International Monetary Fund, 2021). It is increasingly recognized that efforts to formalize the informal sector need to take into account its nuances, i.e. "the diversity of characteristics and drivers of informality" (International Labour Office, 2018, p. V). The ILO advocates policy initiatives that take into account a country's circumstances have the highest probability of success (The Long Shadow of Informality: Challenges and Policies, 2022), and policy

interventions must address the needs of the different groups within the informal sector (Matsongoni & Mutambara, 2018).

5. The Missing Middle

The development literature has discussed the concept of the missing middle, but its existence is highly contested. The “middle” typically refers to the size distribution of firms. Chang-Tai explains, “The idea of the missing middle is that there are a large number of small firms, some large firms, but very few medium-sized firms” (Hsieh & Olken, 2014).

Some scholars have identified the existence of the missing middle (J. Tybout, 2014; For e.g. see J. R. Tybout, 2000) in specific contexts. For example, Atiyas and Diwan examine this phenomenon in the context of the corporate sector in Egypt (Atiyas & Diwan, 2022). They conclude that the corporate sector is dominated by either very large firms or very small firms, and that mid-sized firms are largely missing. They observe that small-sized firms are highly competitive, large-sized firms have oligopolistic advantages including preferential access to finances, while the few mid-sized firms that exist struggle to survive despite their high productivity. They argue that one of the major challenges faced by mid-sized firms is excessive competition from large firms (on the one hand) which enjoy many privileges, and small and informal firms (on the other hand) who are able to keep costs low on account of their informal nature.

In contrast, some scholars have rejected the existence of the missing middle. Hsieh and Olken, examining the manufacturing sectors in India, Indonesia and Mexico, argue that there is no evidence of a missing middle (Hsieh & Olken, 2014):

[T]here is in fact no evidence of a missing middle in detailed and comprehensive data on the size of manufacturing firms in India, Indonesia, or Mexico, regardless of how we slice the data. To be sure, there are many more small firms in developing countries—but while medium-sized firms are missing in the data, large firms are missing as well. Put differently, while there are fewer middle-sized firms in developing countries than developed countries, there is no missing middle in the sense of a bimodal distribution...

Ghosh and Abraham have arrived at a similar conclusion in the context of the Indian manufacturing sector. They conclude (S. Ghosh & Abraham, 2021):

We are unable to find a ‘missing middle’, either at the aggregate or disaggregate level, once we drop the classification of data based on a priori class intervals. We find that most firms in India are small firms and there is no evidence of a clustering of firms at higher size categories.

Some scholars have adopted an intermediate position on the question of the existence of the missing middle. For example, assessing the manufacturing sector in four sub-Saharan countries, Abreha et al argue that “the missing middle is an elusive concept, the controversy around it requires a nuanced approach, and a binary existence statement necessarily rests on identifying assumptions that arguably obscure the relevance of the matter” (Abreha et al., 2022).

Why is this debate relevant? Abreha et al argue that one of the key questions is whether the phenomenon of the missing middle is a problem (Abreha et al., 2022). In response, they argue in the affirmative. They propose that “a missing middle is [] a symptom of an unrealized potential for reallocation of labor across firms” (Abreha et al., 2022, p. 11). The acceptance or rejection of the existence of the missing middle has policy implications, as it impacts the policy recommendations advanced to foster an underdeveloped economic sector.

6. Too hard to go formal and too easy to go informal

DeSoto's *The Other Path: The Invisible Revolution in the Third World* (DeSoto, 1989) and Cooter and Schäfer's *Solomon's Knot: How Law Can End the Poverty of Nations* (Cooter & Schäfer, 2012) explore the challenges businesses face in developing economies, focusing on the informal and formal sectors. DeSoto argues that the process of formalizing businesses in developing countries is overly burdensome, primarily due to excessive regulations and bureaucratic hurdles. He highlights how businesses are often forced to remain informal because navigating the formal sector requires cumbersome paperwork, complex legal structures, and expensive permits often conducive to bribery and corruption. This creates a significant barrier for entrepreneurs seeking to grow

their businesses, leading them to prefer informal, unregulated operations. Cooter and Schäfer emphasize that, for a business to thrive in a modern economy, it must follow a structured progression from informal operations to formal structures, including incorporation, access to capital markets, a predictable and not repressive tax regime, and legal protections like limited liability and bankruptcy laws. However, this progression - from family and friends to bank loans, insurance, and capital markets – can be a challenge, especially for businesses operating in developing economies where legal infrastructure and access to finance are limited or underdeveloped. Ultimately, both sets of authors highlight a critical issue: in many developing countries, it is often much easier for businesses to remain informal due to the barriers to formalization, creating a cycle of limited growth.

7. Case Study: India

The preceding discussion highlights the need to adopt a nuanced approach to understanding and addressing the informal sector (as well as the missing middle). In order to obtain a better understanding of the nuances that may arise, we undertook research studying those sectors that are typically considered to have high informal employment in India (these are the agriculture sector and the manufacturing sector in Sections 0 and 0 respectively) or have a high degree of informality (i.e. the informal housing sector under Section 0) and are often studied in the informal sector literature. We also explore aspects involving the informal sector in India but are rarely discussed in the informal sector literature, i.e. having roots in culture (discussed under Section 0) and informal economies that may arise that are temporal in nature, i.e. occur during certain times and do not function on an ongoing basis (discussed in Section **Error! Reference source not found.**). Our objective is to explore the diversity of the informal sector in India, and the hazards of over-generalization and promotion of formalization across the board.

This section begins with an overview of the informal sector in India (section 0) and proceeds to explore different elements: beginning with the agricultural sector, focusing on small and marginal farmers (section 0). Section 7.3 explores informality within the textile sector, focusing on the handloom and powerloom sectors. Section 7.4 sector investigates informality in the urban housing sector, focusing on urban slums. Finally, Section 7.5 explores informal economies rooted in culture, concentrating on the *hijra* community (members of the transgender community, one of the most marginalized groups in Indian society), the *roodali* community (a distinct group in the state of Rajasthan), and the *Kumbh Mela* (a major religious festival).

7.1 The informal sector in India

In India, employment is overwhelmingly informal (Raveendran & Vanek, 2020). Over 86% of India's workforce is employed in the informal sector (Oxfam, India, n.d.). In urban areas, informal employment accounts for over 75% of total jobs (Oxfam, India, n.d.), while in rural areas it is over 95% (Oxfam, India, n.d.). Agriculture is India's largest employer and it is primarily informal; nearly 99.7% is informal employment (Statistica, n.d.; von der Bank et al., 2024). Even in the non-agricultural sector, over 80% of employment is in the informal employment (International Labour Organization, n.d.-a). Some of the non-agricultural sectors which significantly comprise informal employment include manufacturing, construction, services such as retail trade and restaurants (Oxfam, India, n.d.; Informal Economy in India: Setting the Framework for Formalisation, 2017). Other jobs such as street vendors, domestic workers, drivers and waste collectors are overwhelmingly informal (Raveendran & Vanek, 2020; Statistica, n.d.). Informality is growing in the formal sectors as well, particularly because of outsourcing and use of contract labor (International Labour Organization, n.d.-a). Of the micro, small and medium-sized enterprises, more than 95% are unregistered, with a large number operating in the informal sector (Informal Economy in India: Setting the Framework for Formalisation, 2017, p. 7).

7.2 Agricultural Sector

The Indian agriculture sector comprises informal labor that is extremely diverse, which includes small and marginal farmers, landless agricultural laborers, sharecroppers, and those engaged in animal husbandry. The reasons for informality, challenges faced on account of informality and efforts to address informality-related concerns across these categories sometimes overlap and sometimes diverge. It is beyond the scope of this paper to analyze each category of informal labor. Rather, this paper focuses on one of these categories –small and marginal farmers – to explore the diversity of challenges faced in India in this context. This case study focuses on small and marginal farmers because they make up a significant portion of the country's farmers– over 80% (Dev, 2012; NABARD, 2021; R. B. Singh et al., n.d.) – and they produce over 40% of India's food grains (R. B.

Singh et al., n.d.). Yet, small and marginal farmers own only 33% of cultivated land nationally across India (R. B. Singh et al., n.d.).

Some of the key reforms proposed to aid small and marginal farmers have focused on tenancy security. Regulatory and legislative proposals have often been proposed to address these challenges. For example, the Government of Bihar has proposed a draft Model Contract Farming Act for the benefit of the small and marginal farmers (NABARD, 2021, p. 71) to address contractual issues including mitigating power imbalances during negotiations between the farmer and the purchaser (of farm produce)/ supplier (of seeds, fertilizer, etc).

Most of the literature concurs that lack of tenancy security is a key concern for the agriculture sector and discusses the issue generally in terms of the entire Indian agriculture sector. However, a more nuanced exploration is called for, as the nature and degree of the challenge varies across the States in India. A NABARD 2021 study illustrates this variation. For example, this study finds that in Haryana, a lack of official recognition of tenancy of small and marginal farmers is a key concern (NABARD, 2021, p. 86). Similarly, in Goa, lack of proper land records is a key concern due to legacy issues from the Portuguese colonial rule (NABARD, 2021, p. 78). In contrast, this problem of official recognition of tenancy has not been identified as a key issue in Assam and Gujarat, while in Arunachal Pradesh the majority of land under cultivation is not subject to formal 'ownership rights', as land is cultivated in accordance with customary rights and these rights vary from tribe to tribe (NABARD, 2021, p. 62).

7.3 *Manufacturing sector*

The Indian manufacturing sector is diverse, comprising a variety of activities. These include textiles, food products, wood products, paper and paper products, refined petroleum products, chemical products, rubber and plastic products and metal products. This section focuses on the textile industry, as it is considered the second largest employer in India, after the agriculture sector (Marg & Park, 2020, p. 15), of which a significant portion comprises informal employment.

The textile sector comprises three segments: the large-scale mills, the handloom sector and the powerloom sector. This section focuses on two of these segments. The first, India's traditional handloom sector which involves handspun and handwoven items is primarily informal, and operated on a small scale using traditional methods and tools (CCI India, n.d.; Ramaswamy & Davala, n.d.). It is typically practiced in small towns and rural areas (IBEF, 2024). The second, the powerloom industry, involving the use of modern machinery for mass production, is typically found in semi-urban and rural areas and nearly 80% is in the informal sector (CCI India, n.d.; Ramaswamy & Davala, n.d.; www.fibre2fashion.com, n.d.). The powerloom sector is on a smaller-scale than large-scale mills, but is typically on a larger-scale than the handloom sector. Ramaswamy and Davala observe: "[w]hile the [large-scale] mill sector employs over a million people, the powerlooms, and handlooms employ five to seven times as many people" (Ramaswamy & Davala, n.d.).

While the handloom sector is economically important in India, it also holds historical and cultural value. In India, the handloom sector dates back centuries and played a key role in India's independence movement (Satyasai & Ipe, 2021). The handloom products produced are unique to the region, and nearly every State in India has its own unique handicraft. Handloom work is often homebased, and the knowledge is transferred from generation to generation. While many workers are locals, migrants are increasingly involved in the handloom sector and in some areas form a major component of the informal workforce (For e.g. see Bharadwaj, 2024). One of the biggest challenges faced by the handloom sector is that its products are being replaced by powerloom products, because the latter can take advantage of economies of scale, are produced more quickly and are often cheaper than handloom products. Governments at the Central and State levels have taken several policy initiatives to support the handloom sector, specifically focusing on ensuring its survival despite competition from the powerloom sector. For example, under government schemes handloom products are trademarked, a benefit accorded specifically to handloom products and not powerloom products (M. Dutta, 2024; Ministry of Textiles, 2024).

Unlike the handloom industry, the powerloom industry is not struggling to survive. Because of its economic importance, the governments at the national and State levels have implemented multiple schemes to help foster the industry. These efforts have largely focused on providing financing credit, upgrading technology, and insurance.

Commentaries have found that a vast majority of those informally employed in the powerloom industry are mostly internal migrants, facing appalling work conditions. On account of the fluidity of migrants, they are easy to hire and fire. Migrants are typically paid lower wages than the locals, they live in worse conditions than the locals and have limited to no legal and social protections. To illustrate, a case study from Bhiwandi (housing some of the highest number of powerloom centers in India) (Gangurde, 2018) in Maharashtra concluded that nearly 91% of the workers were migrants including from other States and even from neighboring countries such as Nepal (Gangurde, 2018). Gangurde describes their plight in these centers as follows (Gangurde, 2018) :

Workers live in shockingly unhygienic, cramped conditions. Some even live where they work. Many aren't voters and work too hard to have the time to demand basic facilities like water or sanitation. Diseases are rampant. 'Breathing in the lint makes around 80 per cent suffer from tuberculosis...

Despite government schemes that aim to protect or benefit powerloom workers, many migrants are unable to benefit from these government schemes because of their unregistered status. For example, they are unable to apply for health or accident insurance even if they are hurt on the job (Reetika, 2018): Some commentators have argued that the migrant crisis in the powerloom sector has been politically ignored (Gangurde, 2018; For e.g. see Mahaprashasta, 2022), and targeted efforts must be taken by the government to alleviate their working conditions.

Hence, the challenges faced by the informal sector within the textile industry is not entirely homogeneous, though there are overlaps. The primary concern in respect of the handloom sector has been to help it survive in competition with the powerloom sector. In the case of the powerloom sector, although the government has implemented steps to foster the industry, targeted efforts are called for to address the challenges faced by migrant workers in the sector.

7.4 *The Informal Urban Housing Sector*

The Indian informal urban housing sector – also referred to as unauthorized housing - can be divided loosely into three sub-categories, i.e. those inhabited by (a) the poor, typically referred to as slums or *jhuggis*, (b) the middle-class, and (c) the ultra-rich living in gated communities. Most of the literature on informal urban housing focuses on slums. The focus on slums reflect the concern that typically the poorest, most vulnerable and marginalized live in slums, often severely lacking in basic amenities. Zhang describes their living conditions as: “[living in] insanitary, squalid, and overcrowded conditions; [becoming] a source of danger to their inhabitants’ health, safety, or convenience” (Zhang, 2018, p. 876). This section begins by describing the diversity in slums, then identifies some key reasons for their establishment and expansion. It then identifies some key efforts taken by the Indian Government which focus on formalization and describes some of the key challenges faced in the formalization strategies adopted.

Slums are unauthorized and illegal structures – encroachments built on private or public land – but they are not homogeneous. Slums vary by location, nature of housing, availability of amenities and the characteristics of people living there. Slums may develop in city centres near commercial or residential centers, sometimes they develop on pavements or outside municipal boundaries, and sometimes on land that is generally unsuitable for habitation (Batra, 2021). In some slums people may live in permanent structures, while in others people may live in semi-permanent or temporary structures (Anees, 2024). While in many slums habitants lack basic amenities, some slums have amenities and homes similar to those available in lower middle-income housing (Rains & Krishna, 2022). While many people living in slums are amongst the poorest, most vulnerable and marginalized, with the marginalized scheduled castes and scheduled tribes overrepresented in slums (Rains & Krishna, 2022), members of the middle-class and lower-middle class, even people with college degrees, live in slums when they are unable to access formalized housing (Zhang, 2018). Many people living in slums are migrants and transients, but some have been living in slums for decades, some even for generations (Rains & Krishna, 2022).

Scholars have argued that it is difficult to know the precise number of slums or the number of people living in slums, as there is a shortage of recent data (Desai & Mahadevia, 2014). The most recent national level census on slums in India was conducted in 2011, which estimated that 65 million people (or 17% of the population) lived in slums (Killemssetty, 2024; Rashmi, 2020). In Mumbai, the capital of the State of Maharashtra and one of the wealthiest cities in India, over 40% of people live in slums (Zhang, 2018, p. 876).

A variety of factors have played a role in the establishment of slums in India. These include a high level of urbanization, industrialization in and around cities, flawed regulatory policies including overregulated land regimes and failures of urban planning. Market failures on the supply and demand side, such as high costs of construction, absence of a viable rental market, limited or no savings, uncertain collateral, have contributed to people being unable to enter the formal housing market (Rashmi, 2020; World Bank, 2019). In some places, historical events have played a key role in the establishment of slums. For example, in 1947 the partition of India between India and Pakistan resulted in the influx of high numbers of refugees in Delhi (India's capital city), which the formal housing sector was unable to absorb (Mahdi & Mazumder, 2023). Many refugees began living in unauthorized housing including slums (Mahdi & Mazumder, 2023).

Once formed, slums continue to expand, and there are factors that perpetuate their expansion. For example, the economic activities taking place within slums and the social connections that people make when living in slums makes them attractive to their inhabitants. For example, *Dharavi*, the largest slum in India located in Mumbai, has over a million people living within 2.1km² (Mahdi & Mazumder, 2023). Dharavi houses many micro-businesses such as tanning, leatherworking, recycling and pottery, with a turnover of around \$1 billion (Phillip, 2017). It is estimated that these micro-businesses employ about 80% of the Dharavi residents (Kumaraguru College of Liberal Arts & Science, n.d.). Naik highlighted the significance of social networks in the proliferation of slums through his study of informal rental housing in Gurgaon, a city located in India's National Capital Region (NCR) (Naik, 2015):

[S]ocial networks and migration strategies play a larger role than rental prices and quality of housing and services in determining the typology and location of informal rental housing that a tenant household chooses to live in. For example, Muslim households from Bengal who were found to be poorly educated and unskilled tended to cluster into *jhuggis* despite having higher household incomes than migrants from Bihar and Uttar Pradesh that live in *pucca* tenements. While the former prioritized savings and remittances, the latter emphasized the need for spaces where non-earning women members would feel safe and get some privacy.

Slum-dwellers in India face a range of challenges, based on the nature of their slums, one of them being lack of tenancy security (Batra, 2021). For example, inhabitants of slums that have been 'notified' under the [India] Slum Act are protected from evictions and the government is able to provide basic services to these areas (Batra, 2021; Nakamura, 2014). The tenants can also be eligible for relocation if they are displaced (Batra, 2021). Slums that are not notified under the [India] Slum Act are not eligible for such benefits. Some of these non-notified slums are identified and counted in official sources such as the government census, but not all. Nearly 50% of the slums in India are non-notified (ARISE, n.d.), although the percentage of slums notified in States differ. For example, in 2002 around 83% slums were notified in Andhra Pradesh while only 9% were notified in Delhi (Nakamura, 2014). By 2008, the number of households living in non-notified slums rapidly increased across India, while "[t]he proportion of households living in notified slums has declined from 67% in 2002 to 54% in 2008" (Nakamura, 2014, p. 3423). It is estimated that in 2008 around 2.9 million people were living in non-notified slums (Nakamura, 2014) lacking tenancy security.

The Indian Government's response to the challenges faced by slum-dwellers due to lack of tenancy security sometimes resulting in harassment by landlords, extreme crowding, poor sanitation, lack of basic amenities such as safe drinking water, toilets, among others. has been formalization. The government over the years has adopted a variety of strategies to promote formalization, which have included demolition, relocation and upgradation of slums. The government is increasingly utilizing market-driven strategies, such as privately-built and privately-financed solutions (Agarwal et al., 2013; Batra, 2021).

A key critique of the formalization efforts made by the Indian Government has been that it has been a one-size-fits-all approach and overlooks ground realities (Killemsetty, 2024; Marnane, 2023). Hence, formalization strategies adopted by the government have faced significant challenges. Slums have been demolished for a variety of reasons, including urban beautification and traffic decongestion, as seen in Delhi during preparations for major international sporting events such as the 1982 Asian Games and the 2010 Commonwealth Games (Mahdi & Mazumder, 2023; Burke & Delhi, 2010). Demolitions have been severely critiqued by the international community, scholars and judiciary on human rights grounds. Government's efforts to relocate slum-dwellers to planned residences with basic amenities have often met with failure, with the slum-dwellers refusing to relocate or returning to the original site despite relocation. Relocation efforts (either government projects or

private sector centered) have sometimes failed because they were outside city-limits, making their residences far from jobs and undermining economic and social connections that sustained slum-dwellers (Barnes & Sawhney, 2021; Bhan, 2020; Marnane, 2024). Another major challenge faced is that sometimes it is unclear who precisely is eligible for relocation, and the requirements are sometimes so stringent that many are unable to qualify. Other factors undermine fair and effective implementation, such as rent-seeking behavior and political interests. For example, Rains and Krishna describing the role of political interests in relocation-related decision making explain they were informed by a retired revenue inspector (Rains & Krishna, 2022):

There are no concrete rules. Decisions about who has to be relocated, who has to be given *hakku patra*, all depends on the mercies of officers and leaders... Cases are sped up during elections.

An alternative strategy adopted by the government has been to upgrade slums instead of relocating their residents. Through upgradation, the focus is on improving the basic amenities in existing slums. However, such upgradations are expensive, and hampered by administrative capacity limitations, complex legal decision-making and political interests.

While the focus of government has been on formalization, the literature on informal housing in India is increasingly arguing in favor of the government exploring alternative approaches to formalization. For example, Nakamura argues that social policy should be expanded to include non-notified slums (Nakamura, 2014). Some scholars argue that such an approach is needed to take into consideration the social and cultural value that exists in slums that are overlooked in formalization efforts (Marnane, 2023). For example, Almeroth-Williams notes (Almeroth-Williams, n.d.):

Slum-dwellers have always relied on their social networks for work and support... the policy [of relocation] has a particularly negative effect on women and children. ... women complain that they no longer know their neighbors and so can't share childcare with trusted people.

It may be intuitive to argue that slum-dwellers that have no tenancy security will not invest in the betterment of their dwellings as they may be evicted any at time. However, Nakamura concludes the converse and argues that a more nuanced understanding is needed to understand the relationship between housing investment and tenancy security (Nakamura, 2014):

[A] large proportion of households in non-notified slums invested in their houses even if they lack the legal assurance of their occupancy rights in India. They are inclined to improve their houses because incremental development is in their best strategy, even when faced with the potential discouragement because of a lack of legal tenure security.

Financing options available to slum-dwellers vary and can sometimes depend on the level of formalization of the slum. For example, Ghosh and Guha investigating microfinance institutions (MFIs) as a credit-source for microenterprises in the slums of Mumbai conclude that while MFIs are present in designated slums, their numbers are relatively limited. In these areas, microenterprises often have access to, and sometimes prefer, credit from other formal sources, likely due to more favorable interest rates (C. Ghosh & Guha, 2014). On the other hand, in undeclared slums, MFIs serve as the primary credit provider for microenterprises (C. Ghosh & Guha, 2014). While MFIs have faced criticism for sometimes engaging in predatory lending practices and using aggressive recovery methods (Flintoff, 2010), there are also numerous success stories where MFIs have empowered marginalized communities, including slum dwellers, by enabling them to generate income and improve their livelihoods (For e.g. see *Small Loans Aiding Mumbai's Poor*, 2007). Focusing on slums in Mumbai, Paul concludes that MFIs are more likely to give micro-finance credit to a slumdweller who owns a room in the slum, than someone who rents a room in the slum as the former reflects higher level of stability (Paul, 2014). Alternative methods of ensuring repayment are also used by MFIs. For example, *Svasti Microfinance*, an MFI providing micro-finance credit to the poor in Mumbai slums, leverages peer pressure as a repayment tool, where social cohesion within communities motivates borrowers to meet their obligations (Wall Street Journal, n.d.):

Each person in a group of five or so borrowers, usually women, generally receives the same size loan. They are jointly responsible for guiding each other's investments and ensuring that each member meets his or her repayment installments.

Hence, when exploring options of addressing the informal housing sector a nuanced understanding is needed of the complexities of the challenges, interests and behavior of slum-dwellers, including the social networks that sustain them.

7.5 *Informal economies with their roots in culture*

In India, some informal economies have their roots in culture. In this section, we look at three examples: the first explores the informal economy of *hijras*, who are members of the transgender community; the second explores the culture of *roodalis*, a unique community in the State of Rajasthan; and the third explores the informal economy generated by *Kumbha ka Mela*, a religious festival.

7.5.1 The informal economy of hijras

Hijras are one of the most marginalized members of society in India. They are a subset of the transgender community and are usually described as including intersex individuals. *Hijras* usually identify themselves as neither male nor female, and in India they have been legally recognized as a ‘third gender’ (Josephine Kipgen & Saatvika Rai, 2020). While in ancient India *hijras* were universally accepted and some even held prominent positions, under the British *raj* they were criminalized for their physiology and sexual preferences (Acharya et al., 2023; *India’s Relationship with the Third Gender*, 2018; A. K. Singh, 2022). In modern day, *hijras* are socially excluded, discriminated against, and not given equal access to education, health services and employment (Acharya et al., 2023). The 2011 national consensus estimated that 4.8 million *hijras* live in India (Acharya et al., 2023).

Culturally, *hijras* hold a unique position in society. They are believed to bring the good fortune of fertility. For this reason, *hijras* often go to weddings and homes with newborn babies – albeit uninvited – to wish them good fortune. At these functions, *hijras* dance and sing and for their performance they are paid by the family members. But, even in these interactions, the stigma remains, and family members are scared and sometimes even repulsed by the *hijras*. Examples abound where family members want to pay quickly the *hijras* and have them go on their way.

Hijras are often discriminated against by the formal sector (Acharya et al., 2023; A. Dutta, 2018; Price, 2022). They are not given jobs in the formal sector or those who are able to find jobs have to keep their identity hidden. A few are able to find low-paying jobs with NGOs or other organizations that work in the human rights sector (Price, 2022). But, many *hijras* have to resort to begging and prostitution for their livelihood (Price, 2022; Sahastrabuddhe & et al, 2012). In India, sex work is not illegal, although acts such as solicitation are illegal. Begging is banned in 20 States in India under State law but continues to be widespread across India.

To survive and for their protection, *hijras* have found sanctuary amongst one another. They have their own unique culture and informal institutional structure with its own rules. If a person wants to join a *hijra* ‘family’ they enter through the relationship of *guru-chela* or master-student ((Anh) *Hijras of South Asia*, n.d.; Josephine Kipgen & Saatvika Rai, 2020). The *guru* teaches the *chela* about the lifestyle, which includes how to dress, how to talk, how to behave and how to earn a livelihood. From the money that a *chela* earns, the *chela* gives a portion to the *guru* as a contribution towards the institutional/family running costs (Josephine Kipgen & Saatvika Rai, 2020). Human rights experts have raised concerns that sometimes this *guru-chela* relationship is abused by the *guru*, and it may sometimes become akin to bonded labor (Goel, 2019). *Hijra* families have informal negotiated territory with other *hijra* families, and each has exclusive rights to earn income within specific territories (Josephine Kipgen & Saatvika Rai, 2020).

The caste system significantly influences the livelihood of *hijras*. Anecdotal evidence suggests that sometimes *hijras* from lower castes, particularly *dalits*, face restrictions from earning a livelihood through dancing at weddings and births by their ‘*hijra* family’ (Goel, n.d.). *Dalits*, who are marginalized and subject to systemic discrimination, social exclusion, and economic hardship despite legal protections (Acemoglu & Robinson, 2019; Hanchinamani, 2001; Waughray, 2010), find their opportunities further limited. For *hijras* from these lower castes, their ‘*hijra* family’ may instead encourage them to beg, and if they want to supplement their income then they may choose to take up sex work (Goel, n.d.).

To protect *hijras* and other members of the transgender community, in 2014 the Supreme Court of India categorized them as a socially and economically ‘backward’ class entitling them to access and representation in education and jobs (A. K. Singh, 2022). In 2019, the Transgender Persons (Protection of Rights) Act, 2019 which included *hijras* was passed prohibiting discrimination (A. K. Singh, 2022). In 2022 the Supreme Court of India recognized sex work as a profession (Nair, 2022). It also issued directions to the State and Central Governments that aim to protect the rights of sex workers. In some States, such as Delhi and Haryana, the State is providing *hijras* a monthly compensation of approximately USD23 (*Allowance To Eunuchs*, n.d.; *India To Offer Eunuchs Special Pension Each Month*, 2011). Despite these formalization efforts, *hijras* continue to face discrimination and brutality from the police. During COVID *hijras* were denied vaccination (Acharya et al., 2023). Singh describes how efforts to formalize sometimes fails to translate and achieve its objective (A. K. Singh, 2022):

[*Hijras*] are often unable to obtain identity documents because their gender identity and appearance does not correspond to their sex at birth. As a result, many cannot find housing, education, or legal employment.

7.5.2 The informal economy of roodalis

Roodalis are one of the most unique communities in India, found exclusively in the State of Rajasthan (Kabir, 2024). *Roodalis* participate in the mourning rituals of traditional families. In the event of a death, *roodalis* are hired to show grief which they exhibit by beating their chests, wailing loudly and singing songs (Das, 2023). The exaggerated mourning reflects the high status in society of the family in mourning. (Kabir, 2024) For their services *roodalis* are usually paid a small amount of money, around \$1 a day and food for the duration of the 12 day mourning period (Tripathi, 2021).

Roodalis are all women, who traditionally have been marginalized by society. Many are widows, and some are poor who work as servants in rich households (Kundalia, 2015). Coming together as *roodalis* gives them protection, without which they may be left without income or are mistreated by family members. Kabir describes the status of widows in Rajasthan and the potential safety net that becoming a *roodali* provides (Kabir, 2024):

Because of their widowhood, *Roodalis* are put on the lowest rung of societal hierarchy, and are treated inferiorly. They, like most *Rajput* women, are instructed to stay home. Traditionally, their dwellings are also meant to be on the outskirts of the village, withdrawn from society completely. Widows are regarded to have no value whatsoever, since the husband no longer exists. However, becoming a *Roodali* gives them some distinct identity, no matter how pitiful.

However, with modernization and urbanization the traditional practice of involving *roodalis* in mourning rituals is declining to an extent that it is slowly becoming a relic of the past (Kundalia, 2015). *Roodalis* have to increasingly rely on alternative sources of income, such as animal husbandry, farming and daily wage work (Kabir, 2024).

7.5.3 The informal economy of Kumbha ka Mela

Kumbha ka Mela is one of the largest gatherings in the world, and is believed to have originated over 2000 years ago (Razdan, 2019; Sengupta, 2019). *Kumbha ka Mela* is a Hindu festival that takes place once every three years rotating among four cities (i.e. Haridwar, Prayagraj, Ujjain, and Nasik) across four different States in India, and sometimes more frequently to commemorate important religious dates (Razdan, 2019). It attracts devotees from across the globe. The *Mela* was held in Prayagraj in the State of Uttar Pradesh in 2013, 2019 and 2025. In 2013 approximately 120 million attended the festival, in 2019 around 150 million people (Sengupta, 2019), and in 2025 it is estimated that nearly 400 million visitors will attend (Jeelani, 2025).

The *Mela* is a major source of revenue for the State. Confederation of Indian Industry (CII), an apex trade body representing industries and businesses in India, estimated that the 2019 *mela* generated nearly US\$ 14 billion, while government expenditures were approximately US\$ 500 million (Sengupta, 2019). The government is spending an estimated US\$ 860 million for the 2025 *Kumbha ka Mela* which is expected to generate revenue of US\$ 26 billion (Jeelani, 2025).

The administration of the *Kumbha ka Mela* is described by experts as establishing a temporary or “pop-up megacity” (Johari, 2015; Raj, 2024). Johari describes, “In a span of just three months, government and municipal

officials build an entire city on the 24-sq km expanse, complete with various styles of tent housing, 150 kms of roads, toilets and drainage systems, electricity grids, bridges across the rivers, new bus and train stations and even hospitals” (Johari, 2015; see also Khanna & Macomber, 2015).

The formal and the informal sector co-exist and work simultaneously (Khanna & Macomber, 2015). CII is estimated that during the 2019 *mela* nearly 600,000 jobs were created, of which 55,000 jobs were in the informal sector which included taxi drivers, tour guides, interpreters and street hawkers (Raj, 2024; Razdan, 2019). Raj describes the role that the informal sector performs during the *mela* in catering to the needs of the visitors (Raj, 2024):

These informal vendors play a crucial role in filling the gaps left by formal stakeholders, catering to niche demands that larger companies may not be able to anticipate or quickly address. Their agility allows them to meet the immediate needs of visitors, contributing to a spontaneous yet efficient ecosystem.

The tolerance of government administrators for the stakeholders involved in the informal sector vary based on the pressures created by the *Kubha ka Mela*. For example, Raj describes this phenomenon as follows (Raj, 2024):

On regular days during the 2019 *Kumbh*, [1-2 million] visitors participated, allowing for decentralised and relaxed governance. Informal vendors and smaller businesses thrived during these periods with lower regulation, providing personalised and spontaneous services. In contrast, on peak days when nearly [30 million] visitors arrived, a more centralised and controlled governance structure was required. Business boomed, but regulations tightened. Police and security forces took centre stage, as managing crowds safely and stamped prevention became the top priority.

During the 2025 *Kubha ka Mela* government administrators are engaging the stakeholders of the informal sector in creative ways, such as (Storyboard18, 2024):

Along the banks of the Ganges and Yamuna rivers, 2,000 boatmen are being trained as cultural ambassadors, learning to weave historical narratives into their traditional services. More than 1,000 tour guides are receiving instruction in hospitality and storytelling, while hundreds of street vendors and taxi drivers are learning customer service skills.

8. Conclusion

As we hope our India case study has demonstrated, the costs and benefits of informalization relative to formalization of small businesses, particularly in developing countries, defies sweeping generalizations and factors determining the relationship between the two require granular evaluation on a country, regional, and sectoral basis. Historical factors, informal social networks, and cultural factors all play an essential role in shaping these economies and significantly influence the policies/challenges within different contexts.

As noted earlier, De Soto in a widely-cited book, *The Other Path* (DeSoto, 1989), demonstrated convincingly through simulated studies the barriers to formalization of small businesses in Peru through excessive entry requirements and even where requirements were justified unnecessarily prolix and bribery intensive procedural and bureaucratic hurdles, implying a need for de-regulation in some respects and lighter touch and more efficient regulation in other respects. In similar vein, Cooter and Schaefer in their book, *Solomon's Knot: How Law can End the Poverty of Nations* (Cooter & Schäfer, 2012) argue that efficient laws can facilitate the transition of micro businesses to formal small businesses and in some cases much larger businesses. The World Bank, picking up this refrain, from 2004 onwards (until recently) (World Bank, n.d.) published regular surveys of the time and cost of various basic business in transactions in up to 180 countries in its “Doing Business Reports”.

We do not dispute the importance of reducing the time and cost of transitioning from the informal to the formal business sector. However, as our India case study demonstrates, the virtues of formalization, and impediments thereto, require a much more nuanced and contextual analysis, in some cases requiring a lighter touch by government (e.g. the “license Raj” inherited from the British colonial era), but in other cases requiring a more affirmative role by government, e.g. in affirming tenancy rights for peasant farmers in the agricultural sectors

and the right of migrants to basic protections in the powerloom sector, and more assertive enforcement efforts generally to reduce deeply embedded forms of discrimination based on gender, caste or sexual orientation.

We do not claim that the India experience can be generalized to other developing countries. Indeed, our conclusion in the converse: short of country, regional, and sectoral analysis of conditions and potential policy options (which will require frequent re-evaluation for efficacy), generalizations about the relative economic and social virtues and vices of informalization versus formalization of small businesses and antidotes thereto have very little policy relevance (Prado & Trebilcock, 2021b, pp. 164–165).

Future research could explore comparative analyses of informal sectors across different developing countries to identify common patterns and unique challenges. Additionally, longitudinal studies examining the long-term impacts of formalization policies on marginalized communities would provide valuable insights for policy refinement.

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