Informal Economy and Poverty Dynamics: A Review

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Abstract

Background: The informal economy is an important phenomenon in developing countries. In recent years there has been an increasing policy interest in the informal economy and its poverty dynamics.

Objective: This paper explores the relationship between the informal economy and poverty through literature review of internet based open access resources published from 2000 to 2019.

Method: Many empirical studies in our review have shown that informal employment has a causal impact on household poverty. This paper seeks to evaluate how informal economy through the theoretical lens applied to real world problems and explore the potential value of empirical evidences in progressing new understandings of the linkage between informal economy and poverty.

Findings: Informal economy is the main source of livelihood for marginalized and poor and earnings from this sector have had a strong impact on the household livelihood. It is important that policymakers recognize the informal economy as a positive contribution to poverty, especially in countries where formal economic activities are less in operation.

Conclusions: This study identifies the role of informal economy in poverty dynamics and important policy debates which provide directions to improve the quality and consistency for future research.

Keywords: Informal economy, poverty

Paper Type: Review Paper

JEL Classification: E26, E13
Introduction

In recent times, there has been increasing researcher interests on informal economy and consequent poverty dynamics. The term informal economy was introduced in two African studies — Keith Kart (cited in Hart, 1973) used the term in his study entitled ‘Informal Income Opportunities and Urban Employment in Ghana’ and ILO experts used the term in an empirical study conducted in Kenya in the early 1970s (Giotto & Baccheschi, 1972). These two studies have increased the interest in informal economy (Coletto, 2010). Hart (1973) defined informal economy as consisting of units engaged in the production of goods or services with the primary objective of generating employment and income, typically operating at a low level of organization, with little or no division between labor and capital as factors of production.

The informality is generally shortened to the last five decades, when population migrated from rural to urban areas as a result of rapid population growth (Gaiger, 2019). During the 1990s, globalization of the economy contributed to the informalization of the workforce in many industries in many countries (Standing, 1999). Globalization generated new jobs — both in formal and informal sectors — as it opened new markets (Rodrik, 1997). Chen (2012) argued for the renewed interest globally in informal economy. The informal economy engages much higher number of workforce globally than in formal economy. The ILO estimated two billion people engaged in informal sector as compared to 1.2 billion of the formal sectors in the world (Bonnet et al., 2019). The size and importance of the informal economy has continued to increase not only in developing countries but also in developed countries following the economic depression of the late 1970s and early 1980s (Fall, 1989; Galdino et al., 2018).

Informal economy plays an important role in the lives of the poor. Low income households depend on various forms of unregulated work in order to make their ends meet (Bonnet & Venkatesh, 2016). The fact is that majority workforce of informal economy are the poor. Poverty is a characteristic phenomenon of these households living below the poverty line. Informality, on the other side, includes a large fraction of workers with low earnings. Hence, low incomes appear as the link relating informality and poverty (Devicienti et al., 2009).

The aim of this paper is to present a theoretical review of literature on the linkage between informal economy and poverty. In particular, we seek to evaluate how informal economy as a theoretical lens applied to real world problems and explore the potential value of literature in progressing new understandings of informal economy. Theoretical multiplicity can be defined as a meta-paradigmatic approach which recognizes the value of exploring areas where theories overlap or can inform each other without undermining the distinctiveness of individual theories (Karpouzoglou et al., 2016). This fact is backed by Moher et al. (2009), a systematic review is a review of a clearly formulated question that uses systematic and explicit methods to identify, select, and critically appraise relevant research, and to collect and analyze data from the studies that are included in the review. There is a dearth of systematic review that synthesizes the present state of knowledge on the linkage between the informal economy and poverty.
This paper contributes to the body of knowledge on informal sector and its linkage with poverty by synthesizing available open access literature on informal sector and its linkage to poverty with trends and thematic scope, conceptualization of informal economy, its measurement, and issue of poverty.

The organization of the study is as follows: Section 2 discusses the methodology of the study; Section 3 presents the result and discussion while Section 4 concludes with recommendation.

Research Method
The study was conducted in several steps. First the sources of literature were defined followed by selection criteria. The selection criteria comprised of inclusion and exclusion criteria. Finally the available literature was reviewed in terms of its objectives, methodology, findings and policy recommendations.

Literature Sources
A systematic literature review is a method of making sense of a large body of information, and a means of contributing to the answers to questions about what works and what does not – and many other types of questions too (Petticrew & Roberts, 2008).

The purpose of this review is to document and give a brief account of theoretical knowledge on informal economy and poverty dynamics with empirical evidences. In consideration with the time and resource constraint, we relied on electronic database available online and free of cost only. Google and google scholar are popular search engines while the Economic Literature Index such as ScienceDirect, JSTOR, econlit, economic literature index etc. provide a good coverage of both informal economy and poverty dynamics literature. Key elements such as “informal economy”, “informal economy and poverty” “poverty” “determinants of informal economy” among others were used to identify relevant studies. All documents reviewed in this study were collected during January 15 to March 15, 2020. Inclusion and exclusion criteria were developed for screening the relevant studies on informal economy and poverty dynamics. Our literature survey focused only on open access online sources. There are different types of electronic resources such as journal articles, studies conducted by international institutions such as the ILO, UNDP and academic working paper related to informal economy and poverty in English language.

Selection criteria
In order to conceptualize the literature based on the research studies conducted on informal economy, we applied different selection criteria. There were a number of articles published on economic and sociological aspects of the informal sector in developing countries and developed countries. We did not restrict our search to economic issues alone because both sectors have equal weight to poverty issues in informal economy. First, we restricted our study period to publication from 2000 to 2019. This twenty-year interval allowed the systematic
review to address phases of emergence, maturity and future trends in informal economy and poverty. Given the increasing popularity of informal economy in recent times among the academicians, a challenge of this step was to identify those articles that contributes to poverty related informal economy rather than other different issues on informal economy.

FIGURE 1: Flow diagram of selection decision in this review

In the first step, we only searched simply for informal economy to perform an initial assessment of the literature in ScienceDirect, Google and GoogleScholar using the terms informal economy or informal sector from 15 January 2020 to 15 March 2020. This search provided us with a total of 236 items that included journal articles, research reports and working papers among others. Then our literature was sorted by merging articles together from ScienceDirect, Google and GoogleScholar into one database and duplicates to be excluded from the study. Next, articles were read and evaluated on the basis of language, article type and article published year. Then we applied inclusion and exclusion criteria which helps us to sort out articles further. These criteria were applied first to article abstract, title, keywords and then the full text. This method helped us to narrow down our literature sample. Final literature for the study contained of 12 studies comprising studies within the 2000-2019 time period in developing countries and developed countries. The sample selection criteria have been explained with the help of following figure. In figure 1, the final selection yield 12 articles for this review. The large number of articles were eliminated in step 3 of the process, because large numbers of articles do not specifically deal with poverty approach of informal economy.


**Literature classification**

After selection of articles, we read the full paper to identify and classify the type of each article in terms of method, article orientation (conceptual, qualitative, quantitative or mixed), the theory used, the general theme of the research, the main findings. This also ensures that all the summary descriptions of the reviewed articles whether it is similar or not on the issue of informal economy to poverty. A matrix of the review of the selected literature with their objectives of study, sources of data, methodology used, main findings and policy recommendation is provided in Table 1.

<table>
<thead>
<tr>
<th>Title/ author/ year</th>
<th>Objectives</th>
<th>Source of data</th>
<th>Methodology</th>
<th>Main finding</th>
<th>Policy recommendation</th>
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<tbody>
<tr>
<td>The informal economy and poverty: evidence and policy review by Williams/ 2014</td>
<td>Explore relationship between informal economy and poverty</td>
<td>Review of secondary sources from UK and European Union countries</td>
<td>Descriptive and simple statistical analysis</td>
<td>Societies with larger informal economies characterized by low level of social protection, lower and less effective transfer mechanism and greater inequality</td>
<td>Formalization of informal economy through policy measures through supportive and regulatory policy measures</td>
</tr>
<tr>
<td>Does the Informal Economy Mitigate Poverty and How Does It Work? The Case of Vietnam/ / Hieu et al. (2014)</td>
<td>Examine the impact of income from informal sector employment on poverty in Vietnam</td>
<td>Vietnam Living Standard Survey 2010 data</td>
<td>Descriptive statistics; Probit and quantile regression model</td>
<td>If informal wage workers and informal self-employed workers are unemployed, it raises poverty rates by 11 and 7 percent respectively; working in agriculture instead of informal household business worsens poverty situation</td>
<td>Informal sector has helped to reduce poverty. Poverty reduction programs need to be closely linked to informal business households</td>
</tr>
<tr>
<td>Informality, gender and poverty Chen et al. /2006</td>
<td>Examine the link between informality, gender and poverty</td>
<td>Secondary data from cross-country sources</td>
<td>Descriptive</td>
<td>Emerging concepts in defining informality; the size of informal sector labour varies across countries and across definitions; employment and earning for informal sector vary across sectors and gender; poverty rates vary across components, gender; addressing informality contributes to reducing poverty</td>
<td>Need for an improved national employment statistics, rethinking economic models of labour market; pursuing inclusive development policy to address poverty through employment</td>
</tr>
<tr>
<td>Estimating informal employment and poverty in India/ Sastry/2007</td>
<td>The relationship between informal sector participation and poverty; role of informal sector employment in reducing poverty</td>
<td>National sample survey of the employed and the unemployed (1999-2000)</td>
<td>Descriptive statistics</td>
<td>The nature and type of work from which the household derives its income varies by state, gender and sector of economy; employment in informal sector varies by gender, consumption spending and poverty level across the country.</td>
<td>Poverty is related more to the nature of employment rather than to the absolute rate of employment; the only solution to poverty lies in employment avenues offering reasonable income</td>
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<tr>
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<tr>
<td>Informal sector and urban employment: small business contribution to large livelihood improvements/ Delbis et al/2018</td>
<td>Examine the role of informal sector in reducing urban unemployment and poverty</td>
<td>Primary data collected from 450 informal sector operators</td>
<td>Descriptive analysis and econometric model of livelihood improvement variables</td>
<td>About 90 percent involved in informal sector have improved livelihood; operators who are native, educated, experienced, profitable and economical have improved livelihood</td>
<td>Informal sector operators are constrained by working capital, working premise, narrow market base etc.</td>
</tr>
<tr>
<td>Individual theory of poverty and informal sector/ Sharma/2018</td>
<td>Identify individual factor determining informal sector income and poverty</td>
<td>Primary data collected from street vendors in Delhi, India</td>
<td>Regression analysis with on age, education, period of stay determining income level</td>
<td>Genetic (age) and individual factor (education) has a positive relationship with period of stay and period of stay has a higher impact of income level Education has a negative effect on period of stay while age has a strong positive relationship with period of stay</td>
<td>Period of stay on same occupation increases income while age and education has a major impact on the period of stay of the vendor than on earning</td>
</tr>
<tr>
<td>Urban poverty, informal sector and poverty alleviation policies in Indonesia/ Tambunan/2004</td>
<td>Examine role of informal sector; rural/ urban poverty trend; impact of poverty on informal sector; examine the causes of urban poverty</td>
<td>Secondary data based on review of statistical reports and other literature; primary survey data in 2003-2004</td>
<td>Descriptive analysis of various poverty measurement indicators</td>
<td>Poverty trend has changed during different periods compared to New order government (1969) with continuous drop till 2002 with some rise during economic crisis 1997/1998. Coping strategy against poverty included forcing vulnerable group (children) to informal sector jobs to complement income; economic backwardness in rural areas the most important cause of urban poverty in Indonesia.</td>
<td>Improvement in labour productivity and distribution of agriculture assets, physical/social infrastructure; employment friendly economic growth policies emphasized</td>
</tr>
<tr>
<td>Whether or not the informal economy as an engine for poverty alleviation in Vietnam/ Nguyen et al./2013</td>
<td>Examine the impact of informal economy on poverty status in Vietnam</td>
<td>Vietnam living standard Survey (2006,2008, 2010)</td>
<td>Descriptive statistics and Econometric model</td>
<td>Household poverty which is currently 10 percent would rise to 33 percent without informal income; the econometric model showed increase in informal economy reduces probability of being poor; education and vocational training reduces probability of being poor while household size and household burden increases probability of being poor.</td>
<td>Poverty alleviation programs should closely link with informal employment and informal sector; poverty reduction programs should target rural households along with education and training</td>
</tr>
<tr>
<td>Informal sector support and poverty reduction/ Eggenberger-Argote/2005</td>
<td>Analyze the causes of high business costs and informality</td>
<td>Review of literature</td>
<td>Review of policy document and practices</td>
<td>High business costs lead to informal sector due to high cost of entering formal sector due to ill designed and unstable rules and regulations; poorly defined and insure property rights; poor quality of infrastructures an several governance criteria</td>
<td>Promotion of formalization of informal sector through policy reforms to reduce cost of business</td>
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<td>Informal sector employment and poverty in South Africa: identifying the contribution of informal sources of income on aggregate poverty measures/ Cichello and Rogan/2017</td>
<td>Examine the role of informal sector employment on poverty reduction</td>
<td>National income dynamics study</td>
<td>Descriptive analysis; Shapley decomposition approach to estimate marginal effect; simulation</td>
<td>Per job impact on poverty is such that loss of 100 informal sector self-employment jobs is equivalent to 63 formal jobs on poverty reduction; Decomposition shows that at the food poverty line, informal regular wage jobs and domestic work have a relatively larger per job impact severity of poverty per job than formal employment; earnings from formal sector job account 24.1 times the amount of overall income from informal self-employment but just 11.4 times the amount of aggregate poverty reduction.</td>
<td>informal sector contributes 63.5 of total income but lead to 42 percent poverty reduction while social grants that constitute 7.1 percent of total income contribute to 20.9 percent of overall poverty reduction.</td>
</tr>
<tr>
<td>Informality and poverty: are these processes dynamically interrelated/ Devicienti et al. /2009</td>
<td>Examine the two way relationship between informality and poverty</td>
<td>Secondary sources from Household survey of Argentina</td>
<td>Bivariate dynamic random effect probit model using panel data</td>
<td>Poverty and informality are persistent processes at individual level; past poverty and informality and past informality and current poverty status constitute interrelated dynamics;</td>
<td>Better access to capital, better labour market institutions and efforts in formalizing non-registered salaried workers can contribute to breaking informality trap and thus to move out of poverty.</td>
</tr>
<tr>
<td>Poverty reduction and informal trade/ Barros and Chivangue/2017</td>
<td>Analyzes relationship between poverty perception and informal trade</td>
<td>Primary data collected from 301 informal traders using structured interviews</td>
<td>Logit model and heterogeneous logit model</td>
<td>Informal trade is perceived as an alternative to in-existent formal jobs; it is perceived serves as a strategy to escape poverty</td>
<td>Transformation from informal to formal sector has not taken places as suggested by Lewis (1994); Need for government support through support, education and skill training to transform to formal sector</td>
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</table>

**Findings**

Our study makes contributions to the informal economy literature by examining the nature of the literature, its trend and the context in which majority of literature are oriented. We clarify the concept of the informal economy and how it has been analyzed and explained in the developing countries context. In the same time, we identify the role of informal economy in poverty dynamics and important policy debates which provide directions to improve the quality and consistency of future research.
Trends and Thematic Scope of the Literature

Figure 2 shows an overview of our systematic review. The thematic scope of reviewed articles has a conceptual orientation and are primarily concerned with the role of the informal economy to address poverty in developing countries and developed countries. But in developing countries there are large number of people involved in informal activities for livelihood. Nguyen, et al. (2013) states that positive contribution of informal earnings to household income is large for poor household in Vietnam. A case of Argentina conducted by Devicienti et al. (2009) shows that informal employment has a casual impact on household poverty. A high percentage of Indian people working in the informal sector are poor (Sastry, 2007).

Reviewed articles were case study dominated with 58 percentage of the total studies reviewed. These cases were oriented from the principle that informal economy can result in better management of socio-economic system of the poor.
The review shows that the number of papers on informal economy and poverty dynamics has increased significantly since 2000 whereas the issue of informal sector and informal economy emerge from 1972. The period of last five years i.e., 2015-2020 has shown higher number of publications i.e., 42% than any other previous five year periods i.e., 16.6%, 25% and 16.6% in the periods of 2000-2005, 2005-2010 and 2010-2015 respectively in the selected period.

The distribution of paper by region indicates that the majority of studies are focused in developing countries, while there are less paper focusing on developed countries. Among them, 75 percent of the published papers have concentrated on developing regions. This fact clearly shows that informal economy emerges where there are more poor people or people living below poverty line indicating that the informal economy helps to generate income for poor people.

**Conceptualization of Informal Activities in the Informal Economy**

The conceptualization of informal economy in this review is in accordance with the definition given by Chen et al. (2006). They argued that the informal economy widely recognizes the inclusion of a range of self-employed persons who work in small unregistered enterprises. The informal sector constitutes a heterogeneous mix of economic activities that are unregistered and, therefore, unrecognised by the government (Delbiso et al., 2018). On the basis of National Accounts of Statistics of India, Sastry (2007) argued that informal economy is unorganized segment of the economy that refers to all operating units whose activities are not regulated under any statutory act or legal provision and/or those which do not maintain any regular accounts. In general, the informal sector includes two types of employment. The first type is self-employed and unpaid family workers while the second one includes wage-employed workers without a fixed employer or social insurance coverage or payment of taxes (Nguyen, et al. 2013).

Castells and Portes (1989), Williams and Horodnic (2017) defined informal economy as a specific form of economic activities for generating income that the social institutes do not regulate in a legal and social environment. Chen (2012) provided a labour based definition that it comprises of all forms of ‘informal employment’—that is, employment without labour or social protection—both inside and outside informal enterprises, including both self-employment in small unregistered enterprises and wage employment in unprotected jobs. It consists of a range of informal jobs. On the other hand, based on economic activities, informal economy refers to unregulated labour intensive activities, self-employed entrepreneurs, small enterprises, activities that take place outside state regulations, unregistered activities (Sindzingre, 2006).

**Measuring the Size of Informal Economy**

It is difficult to measure the size of informal economy with precision due to its nature, activities that are not registered or regulated by the government. The difficulty in measuring informal economy is mainly due to the problem in definition (Teltscher, 1994). Studies generally surveyed individuals, businesses, and governments to collect information related to the informal economy (Galdino et al., 2018).
To measure the informal sector activities, researchers have used various methods (Adhikari, 2011), however, no single method can take into account all the informal sector activities simultaneously due to heterogeneity in the nature of informal economy. Generally, labour force survey, mixed household survey, enterprise survey, economic or establishment census survey, multipurpose household survey, household income and expenditure survey, small and micro-enterprise survey are in practice to collect the data on employment in the informal sector and informal employment ILO. In our review, there was a variation in the sources of information with a high dependence on secondary sources of data collected by national statistical institutions. We found that two third of these studies have used secondary sources and one third have used interviews and survey developed by the authors themselves to collect data in the informal economy and poverty. Usually they focused on market areas with large percentage of informal workers and business activities involved in informal activities.

**Informal Economy and Poverty Issues**

In our literature review, we identified different social and economic issues examined by researchers. Among the issues raised by researchers, literature related to poverty was our main concerns. Informal economy creates different type of economic activities or job for the poor people. An informal industry feeds millions of people every day and employs millions of semi-skilled and under skilled workers (Dawson & Canet, 1997; Adhikari, 2017). A large part of the literature shows that there is a positive relation between informality and poverty alleviation (Hieu et al., 2014). Low-income households depend on various forms of unregulated work in order to meet their basic needs (Bonnet & Venkatesh, 2016). Benjamin et al. (2014) analyzed in World Bank study report that countries with livelihood opportunity and employment for a critical part of population depend on informal sector.

The article reviewed work with the UNDP estimating informal employment and poverty in India (Sastry, 2007) estimated that 92 percent of all workers were in informal employment in India, among them 96 percent of total jobs in rural areas and 79 percent of total jobs in urban were of an informal nature. Delbiso et al. (2018) analyzed how informal sector helps poor based on a survey of 450 informal sector operators and in-depth interviews with stakeholders in Hawassa City, Ethiopia. They found that the improvement in the livelihood of informal sector operators with about 90 per cent having improved their livelihood from the informal sector. Nguyen et al. (2013) analyzed that informal earnings significantly alleviate poverty. On a per-job basis, the poverty reduction associated with formal sector jobs and informal sector jobs is quite similar (Cichello & Rogan, 2017). Another important reviewed paper shows spillover effect of the informal sector in their research finding. Devicienti et al. (2009) showed positive relations between past poverty on current informal employment and from past informality to current poverty status. Our review finds another strong paper that analyzed all developing countries scenario by Chen et al. (2006). It revealed that most of the working poor are engaged in informal employment. Informal trade is an alternative to inexistant formal jobs and represents a strategy for escaping poverty (Barros & Chivangue, 2017).
From the literature reviewed, it was found that formal sector income were quite larger than informal sector income. Workers in the informal sector aspired to move to the formal sector in view of the magnitude, security and stability of income. However, given their low level of education and skills, the income they could earn from the formal sector were quite smaller than what they have been earning from the informal sector despite the underlying risks and uncertainties (Barros & Chivangue, 2017). Most of the available literature indicated that transfer of labour from informal sector to formal sector popularized by Lewis (1954) in his hypothesis is not a reality (Williams, 2014; Delbiso et al., 2018; Barros & Chivangue, 2017).

Available literature was found to use diverse sources of data ranging from primary data collection to secondary sources such as national living standard surveys. These surveys also vary in scope from cross sectional data to panel data. The tools of analysis were also varied ranging from simple descriptive statistics to econometric models for identifying the determinants of income and poverty related to the informal sector. The diversity of study variables ranged from engagement in the informal sector by age, gender, educational status, the period of stay and the perception about remaining in poverty, among others. Relations have also been examined for rural and urban informal sector with distinction for informal labour activities within formal sector to informal sectors.

Some very important insights from this literature review are on the debate between formality and informality (Williams, 2014). There are arguments in support and favour of informal economy. The logic behind informality is that it leads to imperfection in the function in the labour market and is a barrier to the transformation of the components of the economy into a formal sector. Several studies have suggested for gradual transformation of informal to formal labour market through appropriate policy measure.

The contribution of informal sector in raising household incomes of the poor has been less debatable with adequate evidences (Hieu et al., 2014; Nguyen et al., 2013). There is, however, wide variation in the magnitude of contribution to economic activities based on definition of labour force participation (Sastry, 2007). However, the causality of informality leading to poverty or poverty leading to informality is somewhat that policy makers need to be clear on. Devcicienti et al (2009) have produced evidences on the complexity on the issue with recommendations that policy makers ought to break the informality trap through formalization.

More insights into the poverty dynamics of the informal sector has emerged. The studies by Cichello and Rogan (2017) identified that the contribution of the informal sector on various dimensions of poverty such as the head count index, poverty gap and severity of poverty differ compared to their formal sector income counterpart.

**Conclusion and Recommendation**

This study has presented a systematic literature review of informal economy and poverty dynamics, focusing on paper published during 2000-2019. We draw conclusion from different literature that informal economy is the main source of livelihood for marginalized and poor and earnings from this sector have had a strong impact on the household livelihood. It is important that policymakers recognize the positive contribution of informal economy to poverty, especially in coun-
tries where formal economic activities are less in operation. In particular, we seek to evaluate how informal economy as a theoretical lens is applied to real world problems and explore the potential value of theory in progressing new understandings of informal economy.

In conclusion, this review of open access literature covering a period of 2000 to 2019 indicates that the informal sector has emerged as a significant sector of the economy. The reviewed literature identified several factors responsible for its emergence ranging from high cost of business to wrong policies and practices of the government (Eggenberger-Argote, 2005); imbalanced rural urban development (Nguyen et al., 2013); low priority and thus low productivity in agriculture sector along with economic shocks such as inflationary crisis (Tambunan, 2004), declining terms of trade for agriculture sector and so forth. Whatever the reasons for its emergence, the informal sector has been a provider of voluntary and involuntary employment and income for a large section of the population. It has served as a coping strategy for the marginalized population against low income and poverty. Evidences provided by these studies indicate that supporting policies for improving the quality of this sector and gradually helping to formalize this sector should be the policy goal of all countries. As informal sector is a very dynamic sector, there is always a need for more studies to capture the dynamism along with most recent theories and practices to address the problems and prospects of this sector.

Conflict of Interest
There was no conflict of interest while preparing this article.

References