

Promoting productive employment and decent jobs: what should be done about informal employment?

Gordon Betcherman¹

Introduction

Promoting full and productive employment and decent work for all is recognized as a critical element in achieving sustainable development. As such, it figures prominently in Goal 8 of the SDGs. The various targets under this goal speak to multi-faceted challenges involved in achieving this goal. This short paper is concerned with one that is particularly important in the context of developing countries: informal employment. The challenge of formalization is directly referred to in target 8.3 but is also relevant for virtually every target included under Goal 8. Since informality is associated with poverty and vulnerability, low productivity, health and environmental issues, social divisions, and low state capacity, formalization and other means of upgrading informal employment are central to the Sustainable Development agenda. However, informality turns out to be a very complex phenomenon. It encompasses many different forms of livelihoods. It has persisted beyond the expectations of development theorists. And it has raised tough questions for policy-makers. At the end of the day, the implications of informal employment for sustainable development depend a lot on the country context.

Defining and measuring informal employment

The recently adopted ILO recommendation (No. 204) on the informal economy defines it as “all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements”.² While specific definitions can vary, the ILO and many others include in “informal employment” own-account workers, employers, family enterprise workers, and wage employees working in the informal economy or in the formal economy but not registered or participating in formal arrangements like tax and social protection systems. Researchers have long understood that informal employment, in fact, captures an assortment of work and livelihood forms with diverse income and non-income characteristics (e.g., Fields 1990).

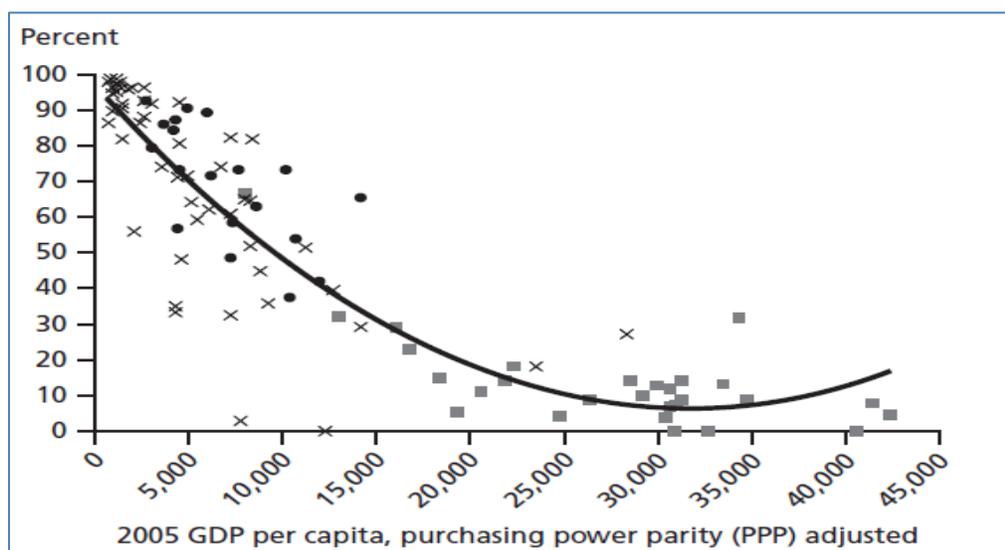
¹ Professor, School of International Development and Global Studies, University of Ottawa. Author e-mail is Gordon.Betcherman@uottawa.ca. This paper was prepared for the Expert Group Meeting on Social Development and Agenda 2030, organized by the Division for Social Policy and Development, UN-DESA in New York on October 21-23, 2015.

² This recommendation, titled the “Transition from the Informal to the Formal Economy Recommendation”, was adopted at the 2015 International Labour Conference. The recommendation can be found at http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO::P12100_ILO_CODE:R204

According to the OECD (2009), more than half of all non-agricultural employment in developing countries (over 900 million workers) is informal. This number climbs to about 2 billion if employment in agriculture is included. The ILO and WIEGO (Women in Informal Employment: Globalizing and Organizing) have assembled direct estimates based on national survey data for 47 developing countries (ILO and WIEGO 2013).³ Of the 41 countries where complete estimates could be made, informal employment accounted for more than two-thirds of total non-agricultural employment in 15 countries and more than half in 24 countries. In almost all countries, the bulk of informal employment is in informal sectors. However, informal employment in the formal sector exists in significant numbers in some countries.

There is a clear statistical relationship between national level of income per capita and informality. This is shown in Figure 1 which uses coverage in a pension scheme as a measure of formal status. However, while informality seems consistently high in very low-income countries, the ILO-WIEGO data reveal some surprising examples of emerging/middle-income countries with extremely high informal employment shares such as India (84%), Philippines (84%), Pakistan (81%), and Peru (71%).

Figure 1 Share of labor force not covered by a pension scheme declines with income per capita



Source: Perry et al. (2007)

In most countries (e.g., 30 of the 41 with data in the ILO-WIEGO database), women are more likely to be employed informally than men. However, there are significant regional differences in the relative informality rates of men and women and the types of informal employment that the

³ Estimates for most countries are based on data around 2009-10. However, only earlier years are available in some cases. Complete statistics on informal employment were not available for all 47 countries, so some observations are based on a smaller number of countries.

two are engaged in. Most studies also show that youth and the less-educated are overrepresented in informal employment (e.g., OECD 2009).

Causes and consequences of informality

First, the consequences. I only deal with income and productivity. There are other relationships that are important in a sustainable development framework such as the links between informality and social cohesion and environment quality but the (more limited) evidence on these links is not covered here.

Research generally finds that informal employment is associated with lower earnings and higher poverty.⁴ However, there is a great deal of heterogeneity in informal earnings (as well as other working conditions). Researchers since Fields (1990) have often distinguished between “upper-tier” and “easy-entry” informal employment, noting that the former includes better jobs and, in fact, can be preferred to formal-sector jobs.⁵ Various studies⁶ show that productivity is lower on average among informal-sector firms than formal ones.

While the evidence may show correlations between informality, on the one hand, and earnings and poverty and productivity, on the other, determining causation is more tentative. That is because informal status is strongly correlated with other individual and firm characteristics that themselves are associated with low earnings and low productivity (e.g., inexperienced and low-skilled workers and micro-, capital-scarce firms). Nonetheless, if more firms were in the formal sector, productivity would increase. And, if more workers had formal employment, poverty and vulnerability would be lower -- even if informal employment acts as anti-poverty tool and safety net in countries with a limited capacity to provide these instruments formally.

So how can countries increase the share of formal employment? The starting point is to understand why workers and firms are in the informal economy to begin with. The traditional perspective has been to view informality through an “exclusion” lens – i.e., that workers and firms would prefer to be in the formal sector but they are excluded because of limited opportunities in that sector. These limited opportunities have typically been seen as the result of regulatory barriers or excessive costs (from taxes, for example) that restrict the creation of formal-sector jobs. Low-productivity workers and firms are most likely to be excluded. However, research especially from Latin America, has shown that some informality is due to “exit” – i.e., choices on the part of individuals and firms to operate informally because they assess that the benefits of formalization are not worth the costs.⁷

⁴ For a review of research in a selection of countries where microdata has been used to examine the formal/informal earnings and poverty relationships, see <http://wiego.org/informal-economy/links-poverty>

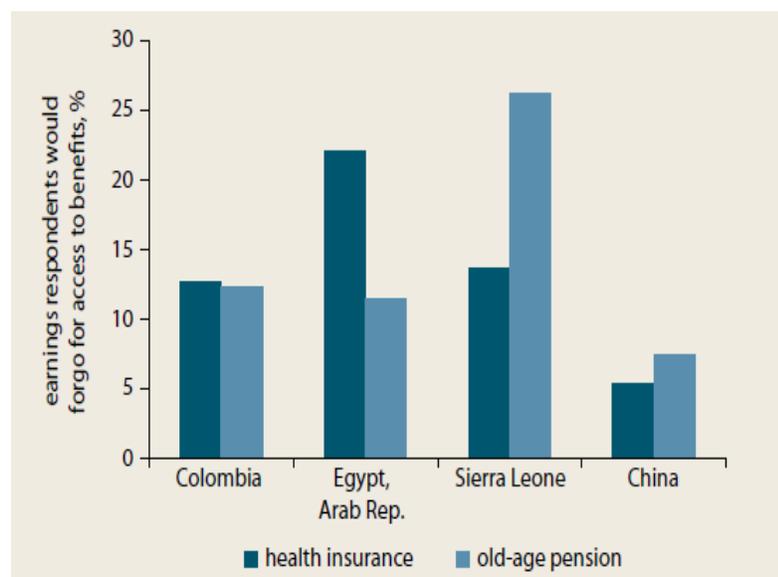
⁵ In many countries, Charmes (2002) found that entrepreneurs in the informal sector have much higher incomes than other categories of informal workers and even the average formal-sector wage earner.

⁶ See, for example, Perry et al. (2007) for Latin America.

⁷ This exclusion-exit framework comes from Perry et al. (2007).

Exclusion is almost certainly the dominant factor in most countries, especially from the worker perspective. For example, surveys show that, in a range of countries, workers are willing to give up earnings for access to formal social protection instruments, like pensions, and to health insurance (Figure 2). However, acknowledging the element of exit is important for putting together an integrated strategy regarding informal employment.

Figure 2 Workers are generally willing to trade earnings for health insurance and pensions



Source: World Bank (2013)

Strategies for addressing informal employment

Somewhat unexpectedly, informality has persisted in much of the developing world and, in some regions, it appears to have increased in recent decades (OECD 2009). This demonstrates how difficult it is to achieve goals related to creating new formal jobs and formalizing informal ones. It also raises the question of whether employment strategies should solely be focused on reducing informality, or also improving the conditions for informal workers.

Measures to increase formal employment must include three broad objectives. The first is to address informality due to exclusion by reducing or eliminating factors impeding the creation of formal jobs. Tax reform is the starting point in countries where tax levels (including social contributions) and the costs of tax compliance are high enough to discourage firms from registering in the formal economy or employing all their workers on a formal basis. High costs of operating formally can also come from overly burdensome business and labor regulations, either in terms of the rules themselves or how the authorities implement them. Lax or discretionary enforcement can also be a problem, even if it reduces the explicit costs of operating formally. Taxes and regulations have important functions in all societies. So the challenge is to find a

balance between fulfilling these legitimate functions while creating a climate that encourages opportunities and removes disincentives for operating in the formal sector.

The second is to address informality motivated by exit. Reducing costs of formalization can play a role here as well by improving the cost-benefit calculations that the self-employed and workers sometimes make in deciding whether to operate in the formal or informal sector (when such a choice exists). But other reforms are needed to enhance the benefits side of the calculations since people are likely to evaluate the costs in conjunction with the perceived benefits they will receive. People want access to public goods and are more willing to pay for them when they are provided efficiently and are of good quality. Similarly, trading off some current earnings to make social contributions is more attractive when workers have confidence in the health services and pensions that these payments are meant to fund. So governance and institutions are an important part of the story.

Third, improving productivity must be central to any strategy to increase formal employment. Although there are some very productive firms, entrepreneurs, and workers operating informally, for the most part informal economies are dominated by struggling micro-firms and low-income individuals with poor prospects of achieving productivity levels needed to operate in the formal sector. Thus, reforms to improve their productivity such as education, innovation, business climate improvements, and urban planning are important.

But should countries focus on formalization or should they focus more on upgrading informal employment? This debate is especially relevant in middle-income countries where developed-country-style social protection seems within reach but formalization is not advancing. In response, universal (non-contributory) social protection and health schemes have been introduced alongside longstanding, but stalled, social insurance plans in a number of countries. Mexico is a good example of a country where universal programs now dominate numerically and the policy dilemmas that this has raised. As discussed in Martinez et al. (2016, forthcoming), this has addressed the coverage problems but there are concerns about the fiscal implications as well as the creation of dual systems in terms of services and benefits provided. Moreover, it has been argued, most prominently by Levy (2008), that the availability of non-contributory schemes will further reduce the benefits of being in the formal sector and, thus, will impede efforts to reduce informality. Martinez et al. (2016, forthcoming), among others, question whether this effect will be significant.

While it matters everywhere, the priority that should be afforded to the issue of formal/informal employment depends to some extent on country context. However it is handled, it is absolutely central to the job challenges facing Mexico and many other middle-income countries where economies have already urbanized and the labor market is predominantly characterized by wage employment. In very low-income countries where livelihoods depend on farming and household

enterprises, formalizing employment may not be the highest priority in the short-to-medium run – increasing productivity and living standards is.

References

Charmes, J. (2002). “Self-employment, Informal Employment, Informal Sector Employment: Trends and Characteristics. A Tentative Assessment of their Statistical Knowledge”, contribution to the ILO/WIEGO report on informal employment for the International Labour Conference 2002 and to *Women and Men in the Informal Economy: a Statistical Picture*.

Fields, G. (1990). “Labor market modelling and the urban informal sector: Theory and evidence,” in D. Turnham, B. Salomé, and A. Schwarz (eds): *The informal sector revisited*. Paris, OECD.

ILO and WIEGO (2013). *Women and Men in the Informal Economy: A Statistical Picture* (2nd ed.). Geneva: ILO.

Levy, S. (2008). *Good Intentions, Bad Outcomes: Social Policy, Informality and Economic Growth in Mexico*. Washington, D.C.: Brookings Institution Press.

Martinez, G., Aguilar, N., and Miranda, M. (2016, forthcoming). “Mexico: formalizing the labor market.” in G. Betcherman and M. Rama (eds.). *Jobs and Development*. London: Oxford University Press.

OECD (2009). *Is Informal Normal? Towards more and better jobs in developing countries*. Ed. by J.P. Jutting and J.R. de Laiglesia. Paris: OECD.

Perry, G.E. and 5 others (2007). *Informality: Exit and Exclusion*. Washington, DC: World Bank.

World Bank (2012). *World Development Report 2103: Jobs*. Washington, DC: World Bank.