

## Informality and Informal Employment\*

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- Strengthen the knowledge base on the diverse nature of informal employment, including its links with the formal labour market, and the costs and benefits of, as well as the barriers to formalisation.
- Focus more attention on workers in informal employment to increase their productivity and earnings, and reduce the risks they face, with the aim of creating more decent jobs.
- Acknowledge the diversity of occupations and job types in informal employment and develop policy packages for the different categories of workers.

### Introduction

Informal employment in its diverse forms is gaining increasing attention within global and national development agendas. The incidence and persistence, and the causes and consequences of informal employment are increasingly being discussed and debated. In this hot topic paper, we take stock of this ongoing discussion with the aim of raising awareness among the policy community that addressing the constraints, opportunities and incentives of informal workers and enterprises is essential for achieving pro-poor growth in both middle-income and low-income developing countries.

Why should we care about informality or informal employment? Firstly, all over the world, the share of informal employment, that is jobs performed outside the formal structures that govern taxes, workplace regulations and social protection schemes, is very high, and increasing. On average, over half of all jobs in non-agricultural sectors in developing and emerging economies can be considered informal. Informal employment is also pervasive in a number of OECD countries, covering well over a quarter of workers outside of agriculture. In some regions, including sub-Saharan Africa and South Asia, this rate is as high as 80% and, for a few countries, even higher.

If informal employment in agriculture is included, the share of informal employment in total employment is even higher: as high as 90% in many countries in South Asia and sub-Saharan Africa (Chen *et al.*, 2005). Recent international consensus emphasises the role of productive employment and decent work for all to achieve sustainable growth and poverty reduction<sup>1</sup>. A poverty reduction strategy that acknowledges the role of decent

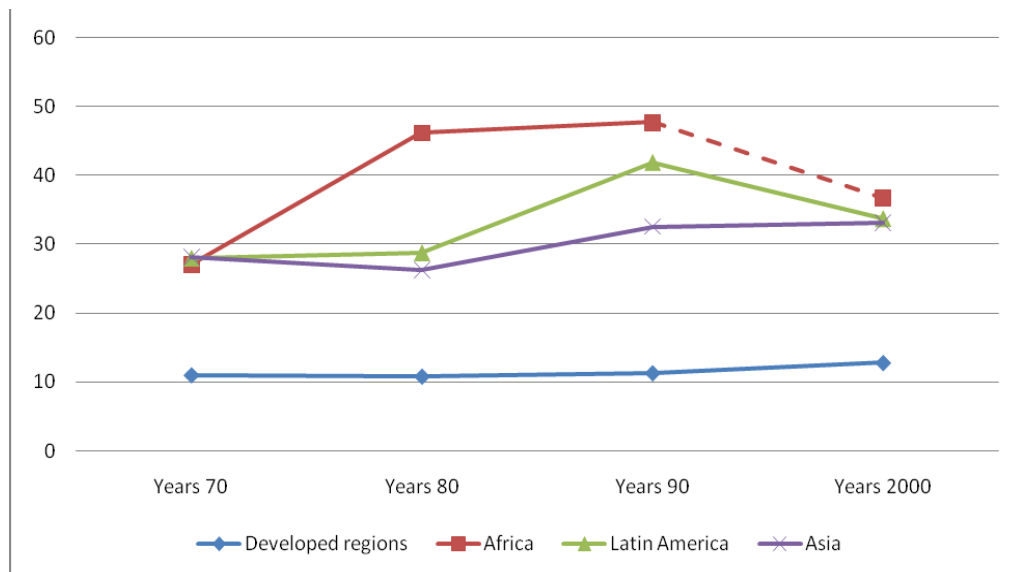
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work for all will then naturally need to focus on informal employment. The informal economy contains considerable unfilled potential to generate growth and reduce poverty.

Secondly, informal employment is not withering away. Non-agricultural self-employment – a proxy for informal employment – has been increasing continuously in absolute and relative terms since the 1970s and across the four decades (Figure 8). It represented 22.5% of total non-agricultural employment in the 1970s, 26.8% in the 1980s, and 31.3% in the 1990s, and it is expected to be at the same levels for the 2000s, when the data for Western and Middle Africa becomes available.

**Figure 8: Share (%) of self-employed in non-agricultural employment**



Source : OECD 2009a

Thirdly, the reasons for informality vary considerably among countries, occupational categories and types of enterprise within a country. For most, informal employment is the only available option and functions as a last resort for people excluded from the formal labour market. A strong link exists between informality and poverty; most of the working poor in the world work informally, either in self-employment or as wage earners. Many of these people lack basic social protection and are locked in low productivity activities, with scant opportunities for economic mobility.

However, being informally employed does not automatically mean being poor, of low productivity and excluded from services and social security. In many parts of the world, the informal economy also includes small-scale entrepreneurs who are not poor and have a large capacity for innovation and a large potential to grow. In addition, as has been suggested by some recent authors, quite a few working people may actively choose informality to avoid paying taxes and complying with regulations, and also to opt out of social insurance schemes and other public services that they consider low quality (Perry *et al.*, 2007; Maloney, 2004; Jütting, Parlevliet and Xenogianni, 2008). However, it is debated to what extent informal employment is a “real” choice and how important this cause of informality is in different country contexts (Tokman, 2008).

## **A new interest in informal employment and its relationship to pro-poor growth**

The renewed interest in informal employment was reflected in and further promoted by the 2002 International Labour Conference Resolution and Conclusions on Decent Work and the Informal Economy<sup>2</sup>. The resolution includes conclusions related to the definition and diagnosis of the informal economy, the main characteristics and decent work deficits of informal workers and informal economic units, and a range of actions to address these decent work deficits and to facilitate integration into the mainstream economy.

The term “informal economy” was considered preferable to the traditional “informal sector”<sup>3</sup>, because informal workers and economic activities do not belong to one sector of economic activity, but cut across many sectors. The informal economy refers to “*all economic activities that are, in law or practice, not covered or insufficiently covered by formal arrangements.*” Informal employment is a broader concept that also includes employment of an informal nature in formal enterprises, as well as wage and self-employment in informal enterprises and households.

Two important factors have contributed to the questioning of the conventional wisdom that the informal economy has little growth potential and that it disappears with economic growth.

### ***The persistence and increase of informal employment***

In many regions informality is on the rise or at least persistent. Even in environments that have benefited from sustained growth, informal employment is often rising faster than formal employment. As an example, self-employment has risen as a share of total employment in India (Ghosh *et al.*, 2007) and nearly 50% of the urban workers in China have no formal contract and often work under precarious conditions. This calls into question the approach of focusing policy interventions on those who are in the formal economy. Instead, the main challenge is to increase the productivity and earnings and reduce the risks of those working informally, with the aim of creating more decent jobs and gradually formalising informal employment.

### ***The diversity of informal employment***

The mainstream economics perspective on informal employment is in the context of labour market segmentation where good formal jobs are scarce and workers outside the formal labour market are queuing for them while working involuntarily in low-productivity informal jobs. However, given the size and diversity of informal employment, we need to look in more detail at the dynamics and segmentation *within* informal employment.

Generally, informal employment can be classified according to major characteristics such as wage employment or self-employment, urban or rural employment, and in informal or formal enterprises. Some major regional differences can be noted among developing countries. Self-employment of various kinds is the dominant form of informal employment in sub-Saharan Africa, accounting for four-fifths of informal employment in Kenya, Ghana, Mali and Madagascar (Heintz and Valodia, 2008). In Latin America and South Asia, informal self-employment and informal wage employment each account for approximately half of the informal workforce. However, while in South Asia most

informal wage employment is within informal enterprises, in Latin America almost half of the informal wage-employed work in formal establishments (Chen and Doane, 2008; Tokman, 2008).

A set of main employment categories of informal workers can be identified to take into account differences in employment relationships. These categories can provide the basis for development of appropriate broad policy interventions.

- Employer-owners of informal firms;
- Own-account workers;
- Informal employees (of formal and informal firms);
- Sub-contracted workers and wage workers for households (domestic workers);
- Wage workers with no fixed employer (casual day workers); and
- Unpaid contributing family members.

The main employment categories could be disaggregated further based on country-specific situations and the relevant importance of different occupational categories. For example, the Self-Employed Women's Association (SEWA), an organisation of self-employed women workers in India, divides its members into four major occupational categories: vendors and hawkers; home-based workers; labourers and service providers; and rural producers (Chen, 2006). Home-based workers and street vendors are two of the largest sub-groups of the informal workforce, with home-based workers perhaps the more numerous but street vendors the more visible. Taken together they represent an estimated 10-25% of the non-agricultural workforce in developing countries (ILO 2002).

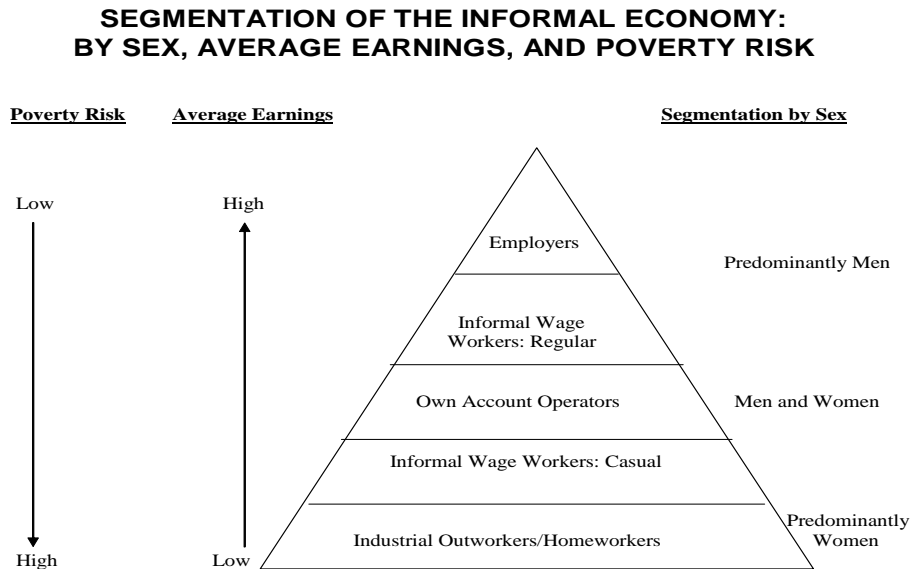
#### **Street trading in Africa**

A regional review of informal street trading in Africa found that street trading accounts for a large share of new urban jobs in sub-Saharan Africa (Skinner, 2008). This growth is a result of a combination of factors, especially urbanisation, migration and economic development. The main concerns of street traders relate to the right to a place to work, and harassment by police, city officials, and retail traders. Other concerns relate to the strong position of wholesale traders and access to capital. Often traders have to borrow from the wholesale traders at very high interest rates. The strengthening of organisations of street traders and the participation of street traders in urban planning are central to addressing these concerns. Some best practices exist in policies to accommodate street traders. In Dar es Salaam, Tanzania, and Durban, South Africa, street traders have been issued licences to operate. Associations of street traders have established good relationships with city authorities and infrastructure for street traders has been established at central locations. However, many street traders are not members of any organisation.

The following pyramid depicts the segmentation within the informal economy by employment status and the relative earnings of different segments (Chen *et al.*, 2005, Figure 9). While micro-entrepreneurs who hire others, that is employers, can have a relatively good income, other groups such as home workers are much worse off. This figure also shows segmentation by sex. In general, men are more represented at the top of the pyramid (as micro-entrepreneurs/employers and informal employees), and women more as unpaid family workers and home workers. Categories of workers also differ significantly in terms of poverty risk, and irregularity and insecurity

of work. The diverse and heterogeneous structure of informal employment calls for policy measures that are adapted to the specific situation of individual groups of employers and workers.

**Figure 9: Segmentation of the Informal Economy: By Sex, Average Earnings, and Poverty Risk**



Source: Chen *et al.*, 2005

### A labour market profile: Tailoring and stitching in Nepal

In Nepal, tailoring is carried out in local small informal shops, whereas stitching is often home based. These activities are done primarily for local clients and local markets, but are also often done for garment makers who subcontract work to local stitchers. Women dominate among garment workers, in particular among home-based workers.

Tailoring and stitching can be done either on a piece-rate basis or through self-employment; in fact, the two work methods may be combined if necessary, that is workers may have more than one employment status at a time. Piece-rate workers do not have a contract and are paid by the owner of the garment business; the self-employed may sell directly to customers or through middlemen. Earnings are low and vary substantially over different periods of the year (24-40% of average income in Nepal). In Nepal, as in other countries, home based work is paid at much lower rates than the same work done outside the home, for example in factory settings.

Tailoring and stitching are caste-based activities carried out largely by the Damai (Periyar), a community so marginalised that other caste groups are very reluctant to enter the sector of tailoring and stitching. Problems with middlemen and contractors are foremost, and delayed or incomplete payments are common. Garment workers report that they need more skills training, more work, and payments on time. They also mention the need for at least a minimum wage, and access to some kind of healthcare, particularly because eye problems, back pain and other health problems affect their ability to work.

Source: HomeNet South Asia and the Institute of Social Studies Trust, 2006

## The drivers and determinants of informality and informal employment

There is an important debate in the literature about what has been driving the increase in the share of informal employment observed in developing countries in the last decades. It is important to understand the drivers of informality in order to be able to design proper policy responses. The literature suggests a set of alternative explanations.

Firstly, informality could to a large extent be seen as a result of the type of development that fails to generate sufficient good jobs for all. This has been accentuated by low capacity in the private and public sectors to accommodate rapid population and labour force growth and has been worsened by labour market discrimination and segregation between men and women, social groups and different occupations.

Secondly, an increase in subcontracting driven by globalisation and economic liberalisation has led to greater diversity in the forms of informal employment. This in turn has led to a greater heterogeneity among informal workers, and an increase in the number of those with higher skills and productive capacity.

Thirdly, formal regulations have mostly been designed for larger enterprises and are therefore often inadequate for the needs and conditions of the growing sector of micro-enterprises. Changes in labour regulations and/or in implementation of labour regulations may also have had an impact on the share of informality in the economy.

Fourthly, there has been informalisation by employers of once-formal jobs as a strategy to lower labour costs and deal with competition.

One important related issue in this debate is whether changes in informality can be attributed to changes in employment arrangements *within* sectors, or to shifts in employment *across* sectors in the economy. This second possibility is worth examining as some economic sectors are especially prone to informal employment relations as we have seen above. An increase of the relative share of such sectors in the economy thus would lead to an overall increase in informality.

However, evidence from Latin America suggests that a large part of the increase can be attributed to increases *within sectors*. For example, Bosch and Maloney (2006) find that 91% of the 4% increase in informality in Mexican labour markets from 1991-5, as well as 90% of the decline to its original level in 2001, can be attributed to changes within sectors. A similar picture arises for most other Latin American countries (Gasparini and Tornarolli, 2007). This evidence suggests that certain jobs that were previously formal have become informal over the last decade(s). Such a tendency also seems to be relevant in South Africa, where informal employment within formal enterprises is becoming an increasing source of precariousness (Altman, 2007; Skinner and Valodia, 2002). For South Asia, Chen and Doane (2008) note that the traditional, industrial and global modes of production that coexist today are each associated with high degrees of informal employment.

## Good and bad practices in addressing informality and informal employment

Traditionally, measures related to informality in employment have been aimed at formalisation of informal activities. These have included measures to improve the overall business environment, to simplify business registration practices and to reduce red tape. However, often formalisation policies have had negative connotations and taken the form of stressing the illegality of informal activities and making it more difficult for informal

economic actors to carry out their activities. This has included measures such as moving street vendors out from central locations, introduction of obligatory cash machines at market places, and stricter enforcement of laws and regulations. The results of these measures are questionable at best. Often, rather than reducing poverty they have contributed to increased poverty and vulnerability by pushing already vulnerable groups of people into even more difficult situations.

More rarely, governments have implemented measures targeted at strengthening the position, increasing the earnings and growth potential, and reducing the risks of informal workers and entrepreneurs. Supplementary to this, a large range of initiatives has been supported by international, non-governmental and private actors throughout the developing world. These include activities in many important but diverse fields such as microfinance, business development services, sub-sector development, vocational training and support to member-based organisations of informal workers. From these types of programmes, good practices can be identified that could be implemented within a more broad-based strategic framework.

### **SEWA (Self-Employed Women's Association)**

The Self-Employed Women's Association (SEWA) is an organisation of poor self-employed women in India. These are women who earn a living through their own labour or small businesses. SEWA's main goal is to organise women workers in order to improve the work and living conditions of the women and their families. SEWA has a membership of over one million workers, all of whom are women in the informal economy from a range of different occupations and trades in both urban and rural areas. To help their members achieve their goals, SEWA engages in what it calls "Struggle and Development": that is, union-style collective bargaining and campaigns to raise awareness, air grievances, and demand change; and development interventions to promote alternative economic opportunities and build assets. The development interventions of SEWA include financial services (savings, loans, insurance), social services (health care, childcare, adult literacy), infrastructure (housing, sanitation, electricity, transportation), capacity building (technical skills, leadership), and enterprise development and marketing services.

*Source: Bhatt, 2006; Chen, 2008*

### **Waste recycling in Durban**

The municipal government of Durban/eThekweni – in cooperation with organizations of informal sector workers – has established buy-back centres in the city to purchase recyclable materials such as cardboard from self-employed waste collectors. Prior to the establishment of the buy-back centres, waste-collectors often had to rely on intermediaries for market access, which reduced their terms of trade and the share of value-added they were able to realise. The establishment of such centres for marketing recyclables allowed the self-employed to sell their services more directly to the companies processing the materials collected. In this way, a targeted, municipal-level intervention was able to increase market access and to create a type of market exchange which was not prevalent before. The development of markets often provides economies of scale which reduce transactions costs. Operating individually, the informal self-employed cannot take advantage of these potential benefits. However, by consolidating the purchase and sale of recyclables by establishing marketing centres, self-employed individuals can improve access to markets, raise productivity, and improve their earnings. Cooperation between municipal government bodies and organizations of the informal self-employed was necessary to realise these collective benefits.

*Source: Heintz and Valodia, 2008*

## Policy lessons and recommendations for donors

The UN Commission for Social Development adopted a resolution in February 2008 that “emphasizes that promoting decent work aims at the overall improvement of living and working conditions for all and encourages efforts, as appropriate to the country context to address the challenge to gradually formalize economic activities in the informal sector”. In addition, a new target to the Millennium Development Goals stresses the role of productive employment and decent work for all in national and international development strategies. However, even if employment has received a more prominent role in the second generation of Poverty Reduction Strategy Papers (PRSPs), a strategic approach targeted at informal employment or decent work for all is still to a large extent lacking (ILO, 2007).

Formalisation is a multifaceted concept. Traditionally, formalisation has been seen as incorporating informal economic activities into the existing formal regulatory frameworks, primarily business registration and taxation. However, formalisation must be seen more broadly than this and should include access to the rights and benefits associated with formality. As a formalisation policy needs to identify and address the barriers to formalisation, it also needs to take into consideration the limits to formalisation. As a consequence, specific measures and services should be targeted directly at informal workers and informal entrepreneurs. Donors could play an important role in promoting a more balanced approach to formalisation.

The 2002 ILO Resolution states that “the promotion of decent work for all workers, women and men, irrespective of where they work, requires a broad strategy: realizing fundamental principles and rights at work, creating greater and better employment and income opportunities, extending social protection, and promoting social dialogue”. A strategic agenda for formalisation would then need to include a holistic approach to reducing the decent work deficit of both formal and informal jobs. It is vital to better integrate the employment creation and the social protection agenda of informal workers into poverty reduction and development strategic processes. This would include better integrating broad employment objectives into macro policies (taxes, fiscal issues) and sector policies (such as labour, education/skills, infrastructure, social protection).

### *Towards a three-pronged strategy*

Effectively addressing informality needs to start by understanding the costs and benefits for those employed within different segments of the informal economy. Where people have chosen to leave the formal sector, they need to be given incentives to rejoin it. Benefits should be linked to social contribution levels, while administrative procedures such as business and workers’ registrations should be simplified. Apart from positive incentives, reducing informal employment also implies strengthening enforcement mechanisms. However, policies also need to adequately address those who have no choice but to work informally. Such people need a different approach from those who voluntarily opt out of the formal sector. Poverty-alleviation programmes can tide over people whose options for entering the labour market are limited. A better understanding of the complexity of informal employment and a more nuanced approach to addressing the specific needs of informal workers are urgently needed.

Informal employment comprises various phenomena that require distinct policy approaches. The recent OECD Development Centre publication “Informal Is Normal?”

therefore calls for a three-pronged strategy that should be adopted, depending on the specific situation in a country.

The following components can be identified:

- For the world's poor, working informally is often the only way to participate in the labour market. Policies should consequently try to unlock these people from their low-productivity activities, enable them to be more productive and provide them with economic opportunities on fair terms. Specific recommendations include active labour market policies, such as training and skill-development programmes, for those in informal jobs; and credit, business development services, improved technology, as well as market access and knowledge for those who operate informal enterprises.
- If informal employment is a deliberate choice to avoid taxes or administrative burdens, governments should aim to establish efficient formal structures designed to encourage people to (re-)join the formal market. Countries should aim to introduce formal structures that can offer the same (or higher) levels of the flexibility and efficiency that informal channels occasionally offer. In this way, informal entrepreneurs, who frequently have strong innovation and growth potential, can more effectively contribute to the overall competitiveness of a country. Targeting those who voluntarily opt out of the formal sector also involves establishing credible enforcement mechanisms. However, many of those who have informal jobs did not voluntarily opt out of formal jobs – rather their employers in both formal and informal enterprises chose to hire them under informal contracts. Policy interventions need therefore to be carefully designed to distinguish between aspects related to employers who hire informal workers and aspects related to the informal workers themselves.
- In many low-income countries, finally, informal employment is mainly a consequence of insufficient job creation in the formal economy. “Informal Is Normal?” thus also recognises the need for a general push for more employment opportunities within the formal sector. Governments should support small businesses to comply with formal requirements and encourage large companies to create formal employment opportunities.

A broad strategy and policy package for a gradual formalisation of informal activities would include policy measures within four major areas and may include sets of measures designed for country-specific situations and carefully adjusted for different categories of informal workers:

- Adapting regulations to the conditions and needs of informal entrepreneurs and workers, and providing incentives to facilitate registration and legal recognition.
- Empowering informal workers through promoting organizations of informal workers and representation of informal workers in policy-making and rule-setting bodies.
- Increasing the earnings and growth potential of informal workers, for example through vocational training.
- Reducing the risks of informal workers and broadening access to social protection.

A set of broad preliminary policy recommendations for donors could be outlined at this stage, in addition to promoting macro-economic policies that encourage labour-intensive growth and to support the implementation of the policy agenda outlined above.

- Strengthening the knowledge base on the diverse nature of the informal labour market, including the interaction with the formal labour market. Identification of binding constraints for formalisation.
- Supporting the inclusion of decent work for all into development and poverty reduction strategic processes.
- Mainstreaming employment issues for informal workers into programmes in private sector development, infrastructure, agriculture and other related fields.
- Supporting capacity-building for organisations of informal entrepreneurs and workers, and trade unions of informal workers. Strengthening the participation of these organisations in the strategic planning processes.

## Notes

- 1 In 2007 the UN Secretary-General introduced a new target under Millennium Development Goal 1: to achieve full and productive employment and decent work for all, including women and young people.
- 2 Resolution and conclusions concerning decent work and the informal economy, adopted on 19 June 2002, International Labour Conference, 90th Session, Geneva, [www.ilo.org/public/english/standards/reln/ilc/ilc90/pdf/pr-25.pdf](http://www.ilo.org/public/english/standards/reln/ilc/ilc90/pdf/pr-25.pdf).
- 3 The term “informal sector” was coined by a British anthropologist, Keith Hart, in his study of the economic activities of rural migrants to Accra, Ghana in the early 1970s and was popularised and promoted by the International Labour Organisation (ILO) World Employment Mission to Kenya in its 1973 report.



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