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Informal Employment Re-loaded

by

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PREFACE

Employment is back on the international development agenda. The question of more and better jobs for the poor in developing countries was intensively debated in the seventies, but then dropped from the radar screen to be replaced by a focus on social sectors like health, education and more recently ICT. This shift of attention was fuelled by the common belief that through growth, structural adjustment and social development more and better jobs would be created and that a specific "employment agenda" is of no need. Interestingly, this is about to change. Why? Many studies - particular those analyzing "pro-poor-growth"- find that functioning labour markets are key in transforming growth into effective poverty reduction. Labour is most often the only asset of the poor and a growth process that does not create more and better jobs might fail to reduce poverty for a large share of people.

The Development Centre's current work programme addresses these issues with a specific focus on informal employment. The issue of informality warrants specific attention as it is not only the quantity of jobs that matters but equally the quality. Informal employment is frequently understood to mean low-paid jobs without social protection, low productivity and only limited chances to climb up the social ladder. While this is in general true, there are important exceptions, in particular in middle- income countries: people voluntarily opt out or choose to be informal. This raises important questions and issues for research and policy making alike: What is the current state of informal employment? What is the link between productivity, different types of employment and social protection? How do employment, development and social policies inter-relate and how do they shape people's incentives? What are the institutional reforms necessary to achieve greater coherence between employment and development policies?

This Working Paper takes stock of what we know about employment outside the formal labour markets. The persistent conventional characterisation of this type of work as low-paid, unproductive, a last resort when there are no other options, proves too simplistic and does not fully capture reality for all informal workers. Some people voluntarily choose to work "informally" either as entrepreneurs or wage employees. The amount of people working outside the formal labour market is in any case far from negligible: in middle-income countries around a third of the population whereas in poor developing countries this figure easily extends to more than 80 per cent of the population.

The main message for OECD and developing countries alike coming out of this work is not to demonise the reality of informal employment but rather to understand better who is working in what kind of circumstances informally and why; what makes these activities grow or decline and most importantly how can existing policies be made more coherent to create more and better jobs in a globalising economy. To this end, more empirical evidence is badly needed.

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The Development Centre has just started an ambitious undertaking to address these issues in country case studies in Mexico, Romania and possibly others. In close co-operation with the relevant Ministries and in partnership with local research institutes, the Centre seeks to contribute to better understand the informal sector and to provide policy solutions that help to better integrate the employment and social protection agendas.

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RÉSUMÉ

Cette publication porte un nouveau regard sur l'emploi informel, un phénomène qui suscite un regain d'intérêt aussi bien de la part des politiciens que des chercheurs. D'après la publication, l'emploi informel va en toute probabilité durer, qu'il est parfois un choix volontaire, qu'il peut offrir de meilleures conditions de travail que l'emploi formel, il est très hétérogène et diversifié. Les discussions autour des raisons de ces faits étonnants et des tendances sont basées à la fois sur les encouragements et sur les contraintes qui déterminent les débouchés du marché du travail. Remettre au goût du jour l'emploi informel suppose de repenser le programme politique actuel et trace de plus amples directions pour la recherche.

Mots clefs: emploi, secteur informel, protection sociale.

Classification JEL: E26; O17; J43.

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ABSTRACT

This paper provides a fresh look at informal employment, a phenomenon of renewed interest to policy makers and researchers alike. It finds that informal employment is likely to stay, is sometimes a voluntary choice, can offer better working conditions than formal employment and is very heterogeneous and diverse. Reasons for these puzzling facts and trends are discussed by focussing on incentives and constraints determining labour market outcomes. "Reloading" informal employment argues for a re-thinking of the current policy agenda and maps out important further directions for research.

Key words: Employment, informal sector, social protection

JEL Classification: E26; O17; J43.

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I. INTRODUCTION

The concepts of the informal sector, informality and informal employment have been debated since the early seventies, beginning with the launch of the ILO World Employment Programme, the publication of the Kenya Report (1972) and the seminal contribution by Hart (1973). More than three decades later some progress has been made in defining and measuring the "Informal Sector Elephant" (Mead and Morrisson 1996), while much less has been achieved when it comes to understanding the persistence of informality and what this means for policy making (Maloney 2004).

The informal sector has been "re-visited" by Turnham, Salomé and Schwarz (1990) and 14 years later by Maloney (2004). Both reviews are important stock-taking exercises and provide a more nuanced view than the one offered by traditional labour market analysis (Lewis 1954 and Todaro and Harris 1970). This paper provides a fresh look at the determinants of informal employment, taking an individual perspective. Re-loading informal employment is motivated by two important developments: *i)* the recent surge of interest in employment and development by the policy community, and *ii)* the emergence of a "third" view in the academic debate suggesting a segmented labour market within the informal sector allowing to combine the traditional view of segmented labour markets with the competitive labour market hypothesis.

There is an increasing, renewed interest in the relationship between employment, development and poverty reduction. A main outcome of the various "pro-poor-growth studies" is the identification of the employment sector as key for transforming growth into effective poverty reduction (OECD 2006, Osmani 2005, Islam 2004, Lundström and Ronnås 2006). Based on these results policy makers are looking for new insights and advice how to transform growth into more and better jobs. In policy circles, there exists still the widely held belief that those people working informally are forced to do so to ensure a minimum standard of living for their family. Jobs in the informal economy are characterised by "very poor working conditions and low earnings and with no or little social protection" (EC 2007).

On the research side, a long standing traditional view sees informal employment as being the product of a rationing out process in a dualistic labour market. This view holds that well-paid, secured and safe jobs are found in the formal sector, while the informal sector is characterised as small-scale, often not legal, with low productivity and low wages (Lewis 1954, Harris and Todaro 1970). This view has been challenged by those who argue that informal employment is a voluntary choice, thus maximising utility from an individual's perspective (Gindling 1991, Maloney 2004). People opt to work informally because, after weighing costs and benefits, they find that they are not better off working in the formal sector. Recently, a third view has emerged combining aspects of both. Fields (2005) and others argue that in urban informal

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labour markets in developing countries there exists an "upper tier" and "lower tier". The "upper tier" comprises the competitive part, i.e. those who voluntarily choose to be informal and the "lower tier" is the part that consists of individuals who cannot afford to be unemployed but have no hope to get a formal job. In particular the last hypothesis offers interesting, new insights on individuals' motivation to stay informal and has important policy consequences.

According to conventional theory, in the course of development the majority of workers would move from the informal sector to the formal one. However this has not materialised in low- to middle-income countries and informal employment has proven to be more complicated than initially thought. For example, the distinction between "formal" and "informal" occupations has become increasingly flawed as quite some workers have a foot in both sectors. Moreover, there is increasing evidence that tax evasion is not the only reason for which people might choose informal employment and that non monetary aspects of work also matter. These observations as well as the debate on the impact of informality on the economy and the resulting policy consequences call for a more comprehensive and holistic approach than has been applied in the past. In this endeavour it is critical to better understand individual choices: that is, which type of employment people opt for and why.

Against this background, the objective of this paper is to identity the main determinants of informal employment from an individual perspective. To achieve this goal, the paper describes recent trends in informal employment and analyses the underlying causes of informal employment. If the informal sector and informal employment continue to be integral features of the world economy for quite some time, there is a need to develop better instruments, methods and policies to reach out to these people.

The structure of this paper is as follows. Section 2 gives an introduction into the definitional, conceptual and measurement issues related to informal employment. Section 3 discusses some "puzzling" facts related to informal employment that do not seem to be in line with conventional labour market analysis. Building on this, section 4 critically evaluates some existing explanations of informal employment. Additionally, it suggests a more comprehensive analytical framework putting emphasis on the various determinants that influence an individual's decision to engage in formal or informal employment. The concluding section 5 highlights some important policy implications and areas for future research.

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II. CONCEPTUALISING INFORMAL EMPLOYMENT: DEFINITION AND MEASUREMENT ISSUES

The International Labour Organisation is the main international body providing official definitions of the informal sector and informal employment. The first standardised definition was agreed upon in 1993, when informal work was defined in terms of production units: informality in this sense refers to whether a firm is formal or not. For enterprises to be informal they must be owned by individuals or households that are non-separate legal entities independent of their owners; they produce at least some goods/services for sale/barter; they must be of a size below a certain threshold and engaged in non-agricultural activities. This also includes self-employment. Then, employment in the informal sector refers to: *"all jobs in informal sector enterprises or all persons who, during a given reference period, were employed in at least one informal sector enterprise, irrespective of their status in employment and whether it was their main or a secondary job."* (ILO 2002b).

This definition was found to leave out important segments of informal employment, and in 2003 the ILO decided also to include informal workers outside of informal enterprises. In this broader understanding, informal employment is defined as the *"total number of informal jobs, whether carried out in formal sector enterprises, informal sector enterprises, or households"* (ILO 2002b). Informal jobs refer to work outside the regulatory framework because they are not subject to labour legislation, social protection, taxes or employment benefits. Various dimensions here thus determine whether a job is informal or formal, ranging from registration with social protection schemes, to compliance with labour or tax law. On the basis of this definition, several types of workers are identified: own-account workers and employers of informal firms, contributing family workers, informal employees (of formal and informal firms), and members of informal producers' cooperatives[1].

In research and policy analysis, the ILO definitions are not always followed and instead a multiplicity of indicators is used (for an overview of the choice of indicators in some recent studies, see Appendix A). This diversity results, firstly, from the fact that the definition of

[1] In most official statistics, agriculture is kept as a separate sector and is not included in informal employment. According to Charmes (2004, p.3) "the international definition does not recommend to exclude agriculture from the informal sector, but it recommends to clearly distinguish the agricultural informal sector (including animal husbandry, forestry and fishery) from the non-agricultural informal sector". However because of the lack of precise data on agricultural activities, which does not allow researchers to distinguish between market and non market production, sometimes agriculture is excluded from informal employment altogether.

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informality is strongly driven by data availability. The most common way to measure the size of informal employment is through household surveys[2]. As a result, survey questions can dictate the definition used by researchers. In addition, apart from this measurement issue, selection of an informal employment indicator is driven by the goals of the researcher or policy maker involved. While some people are mainly interested in precarious, unprotected work, others are more interested to know whether people engage in black market or unregistered activities. While there is often some overlap among the various definitions, this is not always the case. Therefore, in case comparisons are made across different definitions, clearly the differences have to be well taken into account. Even if the percentages of informality using different definitions are quite similar, it should be remembered that they can refer to very different groups of people, between which the overlap is far from perfect.

As an illustration, Henley *et al.* (2006) investigate the overlap of three definitions of informality extracted from a Brazilian survey, i.e. (1) the absence of a registered labour contract, (2) the absence of pension coverage, and (3) informality as micro-activity. While shares of informal employment for 2001 ranged only from 49.3 per cent to 56 per cent according to the different definitions, these percentages referred to different groups with very incomplete overlap. In fact, only 39.6 per cent of the sample could be categorized as informal according to all three criteria (a strict definition). However, according to a broader definition (at least one criterion of informality), informal employment would be over 63.6 per cent.

To do more justice to the multidimensionality of the phenomenon, informal employment is sometimes also presented as a continuum. A recent ILO report (ILO 2004) presents such a continuum of informality along the following five dimensions: regularity status, contract status, workplace status, employment protection status and social protection status. On the basis of these 5 dimensions, individuals receive scores ranging from 0 (totally informal) to 5 (totally formal). For the countries with available data, the results give an interesting picture of the complexity and diversity of informality across countries.

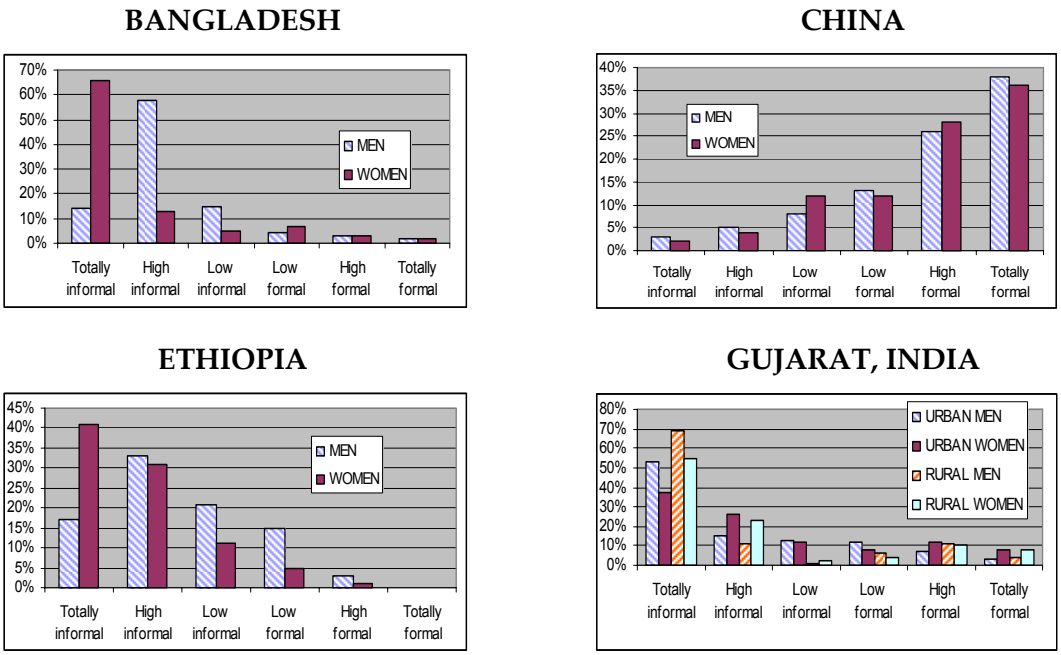
Figure 1 displays these scores of informality for Bangladesh, China, Ethiopia and the Indian state Gujarat. An interesting picture emerges. In three out of the four surveys (Bangladesh, Ethiopia and Gujarat), most people are to some degree informal and only a small share completely informal or completely formal[3]. On the other hand, in China a rather large percentage of people are totally formal, and very few people have totally or highly informal jobs. Still the majority of people are in some way(s) informal. The use of a continuum of informality thus offers a valuable complement to standard one—dimensional indicators of informality. In many cases the majority of people are found somewhere between formal and informal employment, hence important information would be lost if a dichotomous measure was used.

[2] Furthermore, more indirect and rather inaccurate measures are sometimes used. First, there is the residual method, where informal employment is estimated by subtracting from the entire active population the number of formal jobs (see ILO 2002a). Another, very unsatisfactory, way is to use the working poor as a proxy for informal employment (ILO 2007b, footnote 6).

[3] There is a lot of country and gender variation, even within the group of high informality. In addition, disaggregating along the urban and rural workforce as done for the state of Gujarat reveals that a much larger share of the rural workforce is informal to all five dimensions compared to that in urban areas.

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Figure 1. **A continuum of informality for selected countries**



Source: ILO 2004

In conclusion, there is no single internationally accepted and operational definition or indicator of informal employment, and in practice a variety of definitions and indicators is used. Often, data dictates the use of a one-dimensional indicator, but when data allows it, a continuum of informality can show how multidimensional the phenomenon is. As to single-dimensional indicators, it has to be remembered that each describes in fact different phenomena, provides a different aspect of reality and this also has important implications for policymaking.

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III. PUZZLING TRENDS OF INFORMAL EMPLOYMENT

III.1 Persistent informal employment

In general, studies on different regions in the world tend to confirm the persistence or even a rise of informal employment over time[4]. As informality has several dimensions, we will here present evidence of various indicators. First of all, the ILO has gathered a large amount of information on informal sector employment, according to its original definition of non-agricultural employment in the informal sector[5]. The resulting picture in **Error! Reference source not found.** is quite clear. First, informality differs substantially across regions, for 1980-89 ranging from 38.8 per cent in North Africa, to 68.1 per cent in Sub-Saharan Africa. Secondly, informality according to this definition has increased over time in all regions. The biggest rise has occurred in Asia, followed by North and Sub-Saharan Africa.

Table 1. **Employment in the informal sector**

Informal sector as % non-agricultural employment		
Region	1980-89	1990-99
North Africa	38.8	43.3
Sub-Saharan Africa	68.1	74.8
Latin America	52.3	56.9
Asia	53.0	63.0

Source: Charmes 2000, quoted in Beneria 2001, table 6.

As a second example, in Table 2 we report statistics[6] on the share of the informal economy in total output, where the informal economy is defined as unregistered activities. Although this

[4] See ILO 2004; Perry *et al*. 2007 for Latin America; Chen Vanek and Carr 2004.

[5] To be precise, it includes "all non-agricultural "unincorporated enterprises owned by households" and micro-enterprises as well as professional, domestic workers, and home-based workers; it also includes family labour and "employees on an occasional basis"" (Beneria, 2001).

[6] The figures are estimated through indirect methods based on physical inputs (e.g. electricity use), currency demand or a model approach combining several factors. See Schneider 2002 for a more thorough presentation. A more critical account of the use of these methods can be found in Breusch 2005.

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table does not indicate the share of people engaged in the production of this output, the number of people employed in unregistered activities is obviously closely linked to this[7]. Furthermore, it is important to note that involvement in the informal economy is not necessarily the same as informal employment[8]. Nonetheless, the table offers some interesting information. As can be clearly seen, the highest share of the informal economy is found in Africa and South America with around 42 per cent. The OECD countries rank last with a non-negligible 16.8 per cent. As the variation within each group can be considerable, the table also displays respectively the highest and lowest value per group[9]. The table also shows some trends over the years, and this trend is clearly an upward one. As to the OECD region, where informality is unsurprisingly the least relevant, its share rose from 13.2 per cent in 1989/90 to 16.3 per cent in 2002/2003. However, for most regions other than the OECD, data are only available for limited time stretch and this upward trend should thus be interpreted with care.

Table 2. **The informal economy as % GDP, various years**

Region	1989/90	1999/2000	2002/2003
OECD (21 countries)	13.2	16.8	16.3
Greece	22.6	28.7	28.2
United States	6.7	8.7	8.4
Central European and Former Soviet Union Countries (25 countries)	-	38.1	40.1
Georgia	-	67.3	68.0
Slovak Republic	-	18.9	20.2
Africa (23 countries)	-	41.3	43.2
Zimbabwe	-	59.4	63.2
South Africa	-	28.4	29.5
South America (21 countries)	-	41.1	43.4
Bolivia	-	67.1	68.3
Chile	-	19.8	20.9
Asia (28 countries)	-	28.5	30.4
Thailand	-	54.1	52.6
Singapore	-	13.1	13.7

Source: Schneider 2002, 2006. Note: regional values are unweighted averages.

As a third example, below we present some evidence on informality from a perspective of protection of the worker. Systematic information on informal employment according to the availability of social protection or a work contract for all countries is not available. However

[7] The share of informal employment in total employment is higher than the share of the informal economy in total output if on average informal work is less productive than formal work, which is likely the case.

[8] For example, the informal economy comprises illegal activities, which is normally excluded from some informal employment definitions.

[9] In case the ranking changes over time, we display the country with the lowest/highest informal economy share in the latest year available.

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Table 3 presents informal employment for selected Latin American countries according to a definition based on social protection. Based on household survey data from 1995-2004, it displays estimates of the share of workers without social security entitlements. While in some countries informality has declined or remained stable, in at least half the countries there has been a sustained rise, especially since 2000.

Table 3. **Share of salaried workers with no social security rights, selected Latin American countries, 1998-2004 (in percentage)**

	1998	1999	2000	2001	2002	2003	2004
Argentina	37.9	38.3	38.5	38.7	44.1	44.9	-
Brazil	36.4	36.7	-	35.9	36.1	34.8	35.0
Chile	22.9	-	23.7	-	-	22.4	-
Colombia	-	75.1	-	-	-	-	-
Ecuador	60.7	-	-	-	-	72.2	-
El Salvador	48.5	-	47.0	48.0	45.4	48.2	50.3
Guatemala	-	-	65.6	-	59.9	62.8	64.9
Jamaica	-	74.6	-	-	-	-	-
Mexico	57.8	-	55.0	-	59.0	-	60.2
Paraguay	-	73.8	-	72.6	73.8	74.4	76.8
Peru	-	77.2	77.3	73.2	71.9	70.2	-
Uruguay	-	-	-	23.2	23.7	25.8	27.6
Venezuela	35.4	-	31.9	35.6	38.9	41.6	40.2

Source: Socio-Economic Database for Latin America and the Caribbean (CEDLAS and the World Bank). For Argentina, only data for the survey in 28 cities are displayed. For more info see http://www.depeco.econo.unlp.edu.ar/cedlas/sedlac/

We here will not go into details about the causes behind the persistence or increase of informal employment in various parts of the world. One important issue is whether changes in informality can be attributed to changes of informality within sectors, or to sectoral changes in the economy. This second possibility is relevant as some economic sectors are especially prone to informal employment relations as we have seen above. An increase of the relative share of this sector in the economy thus would lead overall informality to increase. Evidence from Latin America suggests that a large part of the increase in informality can be attributed to increases *within sectors*. For example, Bosch and Maloney (2006) find that 91 per cent of the 4 per cent increase in informality in Mexican labour markets from 1991-5, as well as 90 per cent 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 currently become informal over the last decade(s). Such a tendency also seems to be of relevance in South Africa. In fact, Altman (2007) notes that not only the currently informal workers are a cause of concern, but "informality for formal workers may become a more important source of precariousness".

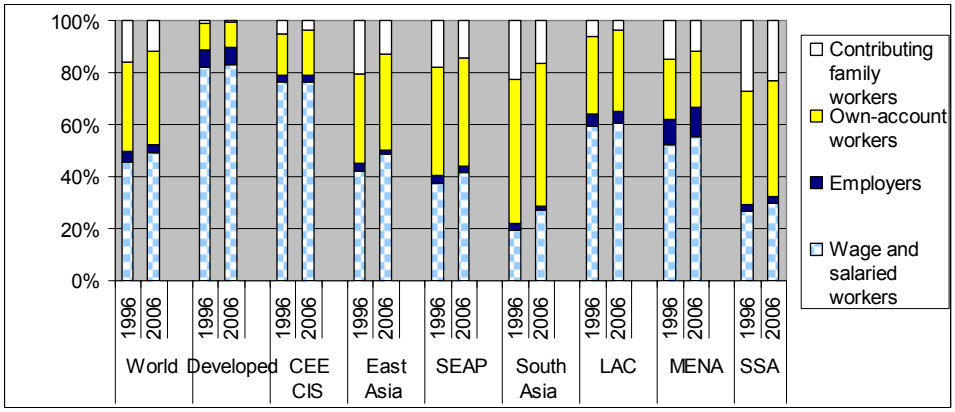
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III.2 Informal employment: a diverse phenomenon

Whichever definition is chosen, it is important to keep in mind that informal employment refers to many different types of workers and activities, ranging from marginal self-employed own-account workers, to well-off entrepreneurs who employ others, and from informal employees of informal or formal firms to contributing family workers.

Figure 2 and Figure 3 display a detailed picture on employment categories: wage work and self-employment, the latter of which is in turn is divided in employers, own-account workers and family workers. It should be noted that these tables do not focus on informal employment only. Although in own-account workers and contributing family workers in developing are regarded informal according to any type of definition, this is not the case with wage workers and employers which can be both informal and formal. Nonetheless, what is obvious is that contributing family workers and own-account workers constitute a very large share (sometimes the single largest) of total employment. Men are most often represented in own-account work, whereas women are engaged most often in contributing family work. For example, the share of women in contributing family work in South Asia was 62.6 per cent in 2006. In contrast, 55 per cent of men in South Asia were own account workers in 2006. In addition, we can witness some changes over time. The share of wage employment in total employment has somewhat risen, especially at the expense of contributing family work. For example, in the MENA region the share of women in wage and salaried work rose from 47.5 per cent in 1996 to 56.2 per cent in 2006.

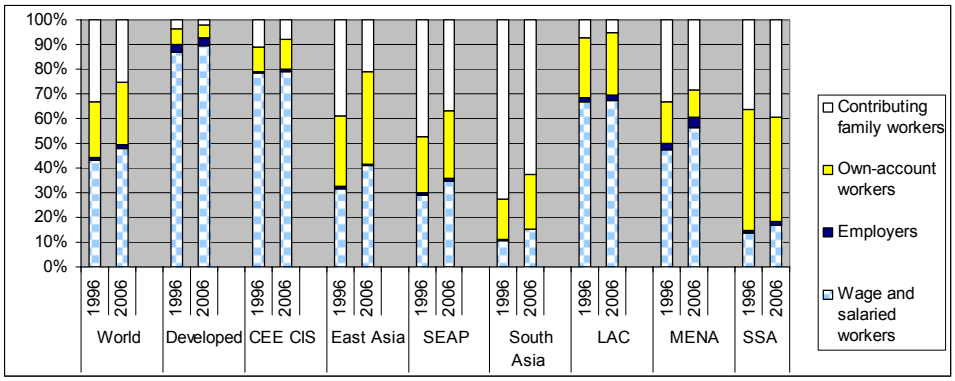
Figure 2. **Employment categories across the world, 1996, 2006 - men**



Source: ILO 2007a. Note: CEE=Central and East Europe, SEAP= South East Asia and Pacific, LAC=Latin America and Caribbean, MENA=Middle East and North Africa, SSA=Sub-Saharan Africa.

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Figure 3. **Employment categories across the world, 1996, 2006 - women**



Source: ILO 2007a. Note: CEE=Central and East Europe, SEAP= South East Asia and Pacific, LAC=Latin America and Caribbean, MENA=Middle East and North Africa, SSA=Sub-Saharan Africa.

The diversity of the sector is also apparent when one looks at the phenomenon of multiple job-holding. In particular, for some people an informal job is the only source of income, while for other informal work can be a complement to formal job earnings. In such a case, people combine a formal job or formal business with a small informal business or informal wage work. While it is well established that multiple job-holding of this kind is widespread, it is hard to establish the extent of the phenomenon as household and labour force surveys often do not capture the existence of several jobs. Table 4 shows for a limited number of countries, whether informal work is performed as main or as secondary activity. In some countries an important share of people is engaged in informal employment in addition to their other job. This is as high as 22.5 per cent in Lithuania and 20.3 per cent in Russia. In some other countries, such as Georgia and Kyrgyzstan, this share is much lower.

Table 4. **Primary vs. secondary job-holding among informal sector workers (in %)**

	Informal employment as…	
	1st job	2nd job
Barbados	88.6	11.4
Georgia	97.2	2.8
Kyrgyzstan	97.6	2.4
Lithuania	77.5	22.5
Russian Federation	79.7	20.3

Source: ILO 2002b. Data are for 1998-2001.

It is important to note that the overlap between formal and informal activities is even more pronounced if we take the household or the family as the unit of analysis. It is indeed the case that many families decide on the division of labour within the household on the basis of expected returns and often choose a smart combination of informal and formal work along with other forms of income generating and risk management activities (e.g. migration).

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Studies show that a non-negligible share of the labour force over time moves between the formal and informal sectors and unemployment, and the other way around. This phenomenon is often studied in relationship to business cycles. Conventional economic theory predicts a movement of workers into informal employment in times of recession, and a decrease once the economy recovers and formal employment picks up. Although most evidence indeed shows a growth of informal employment when the economy contracts, there is also surprising evidence of movements to the informal sector in booms. In such a case, tight labour markets lead workers to look for better jobs and to take the risk of starting a (informal) business and for some this means a move into informal employment, mainly as self-employed. Indeed, these moves from formal to informal self-employment can very well go hand in hand with increases in earnings (see e.g. Packard 2007; Duryea *et al.* 2006; Bosch and Maloney, 2006).

III.3 Informal employment: always bad?

Traditional economic analysis of the informal economy tends to portray informal activity as unproductive and low-paid, a last resort for workers that cannot find a formal job. It may be that many of the informally employed would be better off in a formal position, but recent analyses of gross worker flows mentioned above suggest that in some cases informality is no last resort for workers at all. Informal employment in these cases, in particular self-employment, is not necessarily considered a bad thing.

Various elements are at hand when judging whether workers are better or worse off in their respective jobs (we will come back to this in more detail in section 4). One obvious element of this is earnings. Indeed, it will come as no surprise that informal employment is generally associated with lower wages than formal employment (Chen, Vanek and Carr, 2004; Perry *et al.* 2007; Gasparini and Tornarolli 2007; Bosch and Maloney 2006). However, this aggregate phenomenon conceals some interesting particularities. As mentioned, the studies on gross workers flows mentioned above all highlighted that moves from formal employment to informal self-employment can very well go hand in hand with higher earnings.

In addition to this, non-monetary elements play a role. Although it is hard to gather such information in a systematic manner, there is some exciting new evidence on job satisfaction and happiness of workers measured per employment category. In fact, from studies on Argentina, Bolivia, Colombia and Dominican Republic we learn that an important part of informal independent workers values the autonomy, flexible working hours and good prospects that are related to their work status. In addition, in a Brazilian study, 30,3 per cent of the men and 37,4 per cent of the women in informal salaried work answered they would not like to quit their informal job for a job with a work contract (all studies quoted in Perry *et al.* 2007).

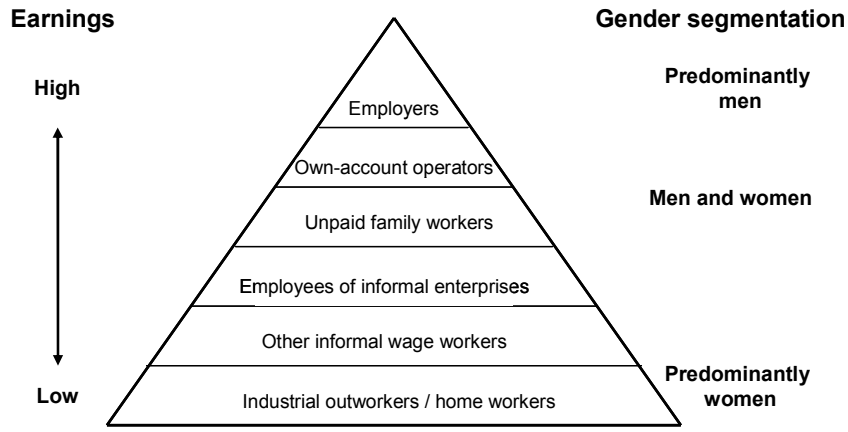
From the above it follows that the relative wages of informal workers differ according to their employment status, and that some compete in their well-being with formal workers while others are clearly worse off (Günther and Launov 2006; Maloney 1999; UNIFEM 2005). Indeed, it is well documented that there are important differences in earnings between the various groups

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of informal workers[10]. Chen, Vanek and Carr (2004) propose the following pyramid to describe the earning status of various informal employment groups (Figure 4). While employers can have a relatively good income, some groups such as home workers are much worse off.

This figure also highlights the distribution along gender lines. In general, men are more represented at the top of pyramid (employers, micro-entrepreneurs), and women more as unpaid family workers and home workers (for this see also Figure 2 and Figure 3).

Figure 4. **Average earnings per informal employment category**



Source: Chen, Martha Alter, Joann Vanek and Marilyn Carr. 2004

[10] See Chen Vanek and Carr, 2004; Perry *et al*. 2007; UNIFEM 2005; Gasparini and Tornarolli 2007.

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IV. UNDERSTANDING INFORMAL EMPLOYMENT: WHAT ARE THE INCENTIVES AND CONSTRAINTS?

IV.1 Challenging the conventional model

In the conventional model of labour markets, informal employment is due to labour market segmentation which implies that those working informally do so against their will. They would have preferred to be in formal employment, given the chance. The evidence presented in the previous section challenges in some respects this conventional view of the informal labour market. Emerging evidence suggests that a share of informal employment is voluntarily chosen and may offer specific benefits and opportunities to certain individuals. In particular, depending on their characteristics, some individuals may have a comparative advantage to work in the informal sector (Günther and Launov 2006). Moreover, many individuals and households may engage in innovative combinations of informal and formal work as risk-coping and income-generating strategies. Thus the conventional way of thinking about informal employment does not seem to fit the emerging evidence and a revised, more complex model, is needed.

Subject to job availability, workers choose the sector and type of employment which maximises their utility. This utility depends on the individuals' characteristics and their preferences, where preferences can be broadly defined to include both pecuniary and non pecuniary aspects of work. In fact, pay and job security, although they are important determinants of utility, are not the only ones. Other factors such as autonomy, flexibility, working hours, distance to work and opportunities offered in the informal sector also determine job satisfaction (Mulinge and Mueller 1998) and may lead workers to choose informal employment (Saavedra and Chong 1999). Overall, as in developed countries, well-being considerations may be very important in shaping employment strategies and individual choices. Individual preferences with regard to pay and non monetary job characteristics vary in important ways and are often shaped by family constraints as well as individual tastes.

Indeed a recent view (Maloney 1999, Perry *et al.* 2007) sees the informal sector as a sector where workers are self selected voluntarily because of the various benefits and advantages that it can offer, or because of the comparative advantage they may have in informal employment. According to this view workers weigh the costs and benefits from working informally versus working in the formal sector and choose the first based on their characteristics and preferences. We should note here, though, that individuals who are voluntarily informal, are not necessarily well off or not poor. Their choice of informality over formal work reveals that, for some reason, they are better off in that position. For example Maloney (2004) uses data from Latin American

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countries and provides evidence that about 60 per cent of people in informal self-employment left their previous jobs and engaged in self-employment in a voluntary manner.

However, it is important to note that not all people in the informal sector are there by choice. Many are found in informal employment because this is their only chance of a paid job. These people are often excluded from all types of social protection and are also over represented among the poor.

In reality these two types of informal employment coexist. Indeed another strand of the literature sees the informal sector as a two-tier sector: the upper tier is reserved to those who prefer informality over a job in the formal labour market and a lower tier composed of those who are there because of no other alternatives (Fields 1990, 2005). For example, Perry *et al*. (2007) show that in selected Latin American countries, the bulk of the self-employed in the informal sector have moved to that sector voluntarily whereas most informal wage employees are found in the informal sector because they are excluded from formal activities. Perry *et al*. (2007) argue that even within this segment of the informal labour market, we can find workers who have voluntarily taken this option. Evidence in favour of "a tale of 2 tails" is also found in Yamada (1996) for Peru and Günther and Launov (2006) for Ivory Coast.

A review of the existing literature in developing countries reveals some interesting features of informal workers. Women are over-represented in the informal labour market (Maloney 2004), both as salaried workers and self-employed. This may be linked to the limited opportunities women in some countries have or, for example, to the downsizing, in many countries, of public employment, which traditionally has been the main destination of women in the labour market. On top of that, and in line with our story that non-pecuniary job characteristics matter, it may be that women value the flexibility and autonomy that informal work offers as it allows them to combine more easily work and family responsibilities (Cunningham, 2001).

Recent evidence (Perry *et al*. 2007) shows that single women are the most likely group to be in formal employment relative to married women and men. However, among married women, those with more young children are more likely to be self-employed in the informal sector, which also suggests a link between family responsibilities and the choice of informal work, in particular self-employment. Maloney (2004) shows evidence from Argentina, Mexico, Costa Rica and Brazil that women with young children are more likely to be self-employed than formal sector employees. Household composition seems to play an important role in choosing the informal sector. Gonzalez de la Rocha and Gantt (1995) show that heads of young families are more likely to be in manufacturing (formal sector) whereas heads of older families can move to riskier but better rewarded jobs as other household members can hedge against risk.

Table 5 provides a short summary of the evidence in the literature, where a positive sign implies that a specific characteristic is associated with a higher probability of formal employment, informal self-employment, or informal wage work respectively. Young workers are mostly found to work as informal paid workers (this is especially true for the less educated ones who have no chance of getting a job in the formal sector (Saavedra and Chong 1999). Older workers are often self-employed in the informal sector. They may be more willing to switch to

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the informal sector as the trade-offs may be less difficult for them. For example, heads of older households, with sons and daughters already working in the formal sector may have to worry less about the benefits of formal coverage, as their children's coverage is often extended to the entire family. The picture in the formal sector is quite mixed, with both young and middle aged individuals working informally.

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Table 5. **Profile of formal employee, informal sector employees and self-employed**

	Formal Sector	**Informal Sector**	
		Self-employed	Salary workers
Age	+/-	+	-
Education	+	+	-
Experience		+	-
Married women	-	+	+
Single women	+		
Children		+	
Household members in formal jobs		+	+
Living in a poor household			+

Note: this table summarise the evidence on the characteristics of people working in the formal sector, in informal self-employment and informal wage work, as found in the literature. For example, a positive sign in the informal salary workers column implies that a specific characteristic is associated with a higher probability of informal employment. For example married women are more likely to be informal salaried workers, or informal self-employed. Individuals living in households with at least one member in formal employment, are more likely to be informally self-employed.

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Education is an important factor determining selection into formal or informal employment. Individuals with no, or minimum education are mostly informal wage employees. Some of the highly educated find formal employment whereas others become self-employed in the informal sector (Saavedra and Chong 1999, Packard 2007). This last group may be choosing to move to informal business for various reasons that we will discuss later.

The evidence on age, education and other individual and household characteristics supports the idea of a life cycle model at the individual level. Individuals start with some years of work in the formal sector or the informal sector (as wage workers), until they accumulate the necessary physical and human capital to move to the informal sector (Maloney 2004, Packard 2007). This idea is indeed consistent with the finding that older and middle- aged individuals constitute the majority of self-employed in the informal sector. On the other side, young workers, who have the necessary human capital, get a formal job. However, for unskilled and disadvantaged young individuals, the main entry point into the labour market remains an informal job. They stay there, often changing employers, until they accumulate the necessary savings, and possibly human capital, to move to self-employment.

IV.2 Costs and risks associated with informal employment

Informal employment is often associated with important costs and risks. Informal workers are over represented among the poor, although it is not very clear which way the causality runs. Moreover informal work is also related to chronic poverty. The costs and risks associated with informal work are summarised in

Table 6 and can be classified in four main groups:

- Uncertainty and vulnerability: Informal work is characterised by higher uncertainty in terms of income flows as well as renewal of unwritten and oral contracts and may be associated with higher unemployment risk (Duryuea *et al*. 2006). Informal activities are often seasonal and thus more dependent on weather conditions and natural disasters.
- Lack of benefits related to formal work: informal workers lack social protection and other basic benefits such as overtime compensation, severance pay, unemployment benefits, sick leave and social protection. Furthermore they have no entitlements for any public social security e.g. accident, health, pensions. This lack of benefits does not allow poor individuals to exit poverty and exclusion.
- Work conditions: informal sector workers may work longer hours and are often exposed to occupational hazards and work accidents. Because unions and workers' association, when they exist, tend to be less powerful than those in the formal sector, workers' rights are not always observed. Besides, informal sector employees have less chance of accessing formal training.

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Table 6. **Costs and risks associated with informal employment**

	Informal Sector	
	Self-employed	Salary Workers
Poverty, exclusion, vulnerability	?	✓✓
Uncertainty in terms of future earnings	✓	✓✓
Uncertainty in terms of contract renewal		✓
Uncertainty in terms of enterprise survival	✓	
Lack of basic benefits (severance pay, overtime, unemployment benefits, sick leave) and social protection	✓	✓
Long working hours		✓
Occupational hazards/ work accidents		✓
Absent (or weak) workers' organisation		✓
High entry cost	✓	
High indirect operational costs (e.g. bribes)	✓	

- High costs: starting up an informal business may require the payment of a significant amount of money as an entry fee. In addition, it may entail prior investment in physical and human capital. Finally, sustaining an informal business can be costly. Although informal entrepreneurs do not pay taxes and contributions, they often pay high fees e.g. in terms of bribes.

IV.3. Benefits and opportunities of informal employment

In this section we briefly review the evidence to show that there are benefits and opportunities associated with at least some forms of informal employment. These benefits go beyond the standard arguments of tax and various contributions avoidance (Cichello *et al*. 2006 for South Africa). Although small enterprises owners may partly choose to stay informal because of fiscal reasons, they may also do so because of other potential benefits of informality. These can range from more flexibility with the work to more autonomy and less administrative burden. It is important to note that these benefits do not equally apply to all people working informally. However, even those individuals who are found in informal work without having chosen it, benefit from some of the opportunities that informal employment may offer. Inefficiencies in formal sector protection and low levels of labour productivity may make informal employment a better option for some people (Maloney 1999, Perry *et al* 2007). The benefits and opportunities offered by informal employment can be summarised in the following categories:

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- Higher pay: individuals with specific characteristics may have a comparative advantage in informal employment. This comparative advantage can be translated into higher earnings compared to potential earnings in the formal sector. Evidence from Mexico (Maloney 1999) shows that movement from self-employment or contract work into formal salaried employment is associated with a decline in wages whereas movement from formal salaried to self-employment or contract work leads to a significant increase. Furthermore, movement from formal salaried and informal salaried work into self-employment is associated with a substantial and significant increase in wages.
- Greater flexibility and autonomy: individuals working in the informal sector benefit from flexibility in terms of working hours and in some cases choice of work location. This aspect may be especially valued by women with children who need to combine work and family (Cunningham, 2001). Working from home may be very interesting for women in some countries, when their physical mobility is constrained by social norms (World Bank 2004).
- Low quality of services and benefits provided by the formal sector: for example social security may not exist or may be of a very poor standard, and there may be uncertainty about the payment of future pensions. High administrative costs combined with low quality of services may discourage some workers from getting a job in the formal sector (Maloney 1999). This is especially true for young workers who tend to be more myopic than older workers, and hence value less old age payments such as pensions. Finally, even within the formal sector there is a high degree of turnover and thus workers often do not benefit from their seniority benefits and pensions (Maloney 1999, Perry *et al* 2007).
- Some "protection" in the informal sector: contrary to the general perception, in some cases the informal sector may not be uncovered/unprotected. For example, sometimes labour market policies such as minimum wages are binding in the informal sector. Various studies (see e.g. Lemos 2004, Maloney and Nuñez, 2003) have found that minimum wages have a significant impact on informal wages in Brazil and other Latin American countries. Furthermore, the household may find alternative ways of social protection at the household or family levels. For example, within a family, the optimal strategy may imply formal employment for one or more members which provides social protection and other benefits to the entire family, and informal employment for the rest of the family. Galiani and Weinschelbaum (2006) find that secondary workers are more likely to work in the informal sector if someone in the household has a formal job. In the same line, Maloney (1999) argues that the marginal value of formal sector benefits for a second worker in a household may be zero, which could go some way in explaining why individuals in larger households may choose work in the informal sector.
- Training opportunities and access to informal networks: working in the informal sector may be the only chance of accumulating experience or even of training and apprenticeship for low-skilled young workers or unskilled older individuals. Moreover, talented workers may have better prospects for upward mobility in the informal sector. Finally access to informal networks through informal employment can in certain cases be effective in providing some sort of unemployment and health insurance.

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Table 7. **Benefits and opportunities of informal employment**

	Informal Sector	
	Self-employed	Salary Workers
Flexibility, Autonomy	✓	
Working hours flexibility, choice of work location	✓	✓
Higher potential earnings	✓	
Training opportunities	✓	✓
Accumulation of work experience	✓	✓
Career prospects/ upward mobility	✓	?
Access to social networks	✓	✓
Tax, social security and other contributions avoidance	✓	✓
Low quality and high uncertainty of formal sector benefits (e.g. social protection, pensions)	✓	✓

IV.4 Towards a more complex framework of informal employment

Having briefly reviewed the evidence on the attractiveness and risks of informal employment, one main issue prevails: the selection of individuals across sectors and types of employment cannot be described in a simple framework, distinguishing between formal and informal employment and between self employment and wage work. Many other factors need to be taken into account. For instance migration, either internal or international, is a major household risk-coping and income generating strategy and it should be also included in the framework. Moreover, informal work, formal employment and migration often coexist within a given household. More importantly they can also be used together by the same individual wishing to maximise his or her utility and income.

First, migrating within the country or abroad is a common used strategy to cope with risk and increase household income. Second, it seems that the decision individuals have to take is not so much a choice between formal and informal employment, but rather the choice between salaried work and self-employment. Consequently in

Figure 5 we provide a simple revised model of labour market decisions in two stages. Once the decision to enter into the labour market is taken, the decision must be taken whether to migrate, to become paid workers or to become self-employed (a fourth labour market state includes unemployment). In a second stage, the selection in formal or informal employment takes place.

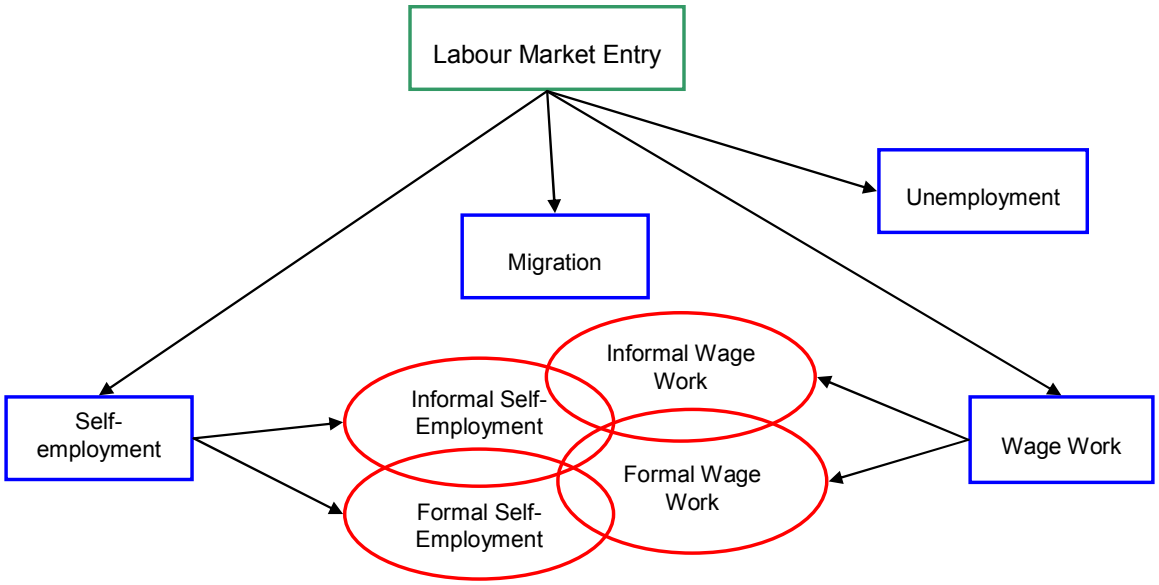
The selection in different forms of employment and the choice among different income generating strategies is determined by the characteristics of the labour market and the economy and hence the characteristics of potential jobs. However on top of that, individual characteristics

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and preferences determine the choices that individuals make between self-employment and wage work, informal and formal employment or migration as well as their selection into a specific labour market status with or without their will.

Figure 5 shows areas of intersection between different types of employment. For example, a formal worker may have a small informal (family or not) business and/or can be engaged in an informal paid activity. Distinguishing among these various activities can be difficult, especially given the available data source, mostly household surveys, which only report the main - and at best the secondary - occupation and activity of the respondent. At the household level, all these strategies, including migration, can be pursued at the same time.

Figure 5. **Elements of a revised framework of labour market statuses**



The above framework can potentially describe not only the individual decisions but also those of the households or the extended families. This may be appropriate given that often the choice between formal and informal employment depends on the household structure and the labour market status of other household members. The benefits and costs of work in the different sectors are viewed in light of the household composition and the labour market status of other family members. Moreover the life cycle model briefly discussed in the previous paragraphs can be extended to the household level. As time goes by, the size, education and age composition of household members change and, along with it, labour market choices may change. In addition, migration history or tradition in the household can determine future choices.

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V. AN EMERGING AGENDA: POLICY AND RESEARCH CHALLENGES

This paper provides a fresh look at the determinants of informal employment from an individual perspective. It offers a complementary, sometimes challenging view to the traditional thinking on labour markets and formal and informal sector linkages. Whereas most of the existing studies discuss determinants of informality from a macro perspective by looking into its relationship with government policies and institutions, this paper emphasises the individual perspective. The observation that informal employment is not declining while the economy is growing, the increasing awareness of the heterogeneity of jobs and working conditions within the informal sector and the increasing blurred line between the formal and informal, questions the relevance and effectiveness of existing labour market, productivity and social protection policies. Although the segmentation between formal and informal work becomes less and less clear, existing policies do not seem to take this account. On one hand, many benefits available to informal workers and the self-employed are mostly provided by social assistance programmes which target poor individuals and households. On the other hand, individuals working formally are basically covered by labour market and social protection policies, designed specifically for those in formal employment. This creates a clear cut dichotomy in the types of policies directed towards people in formal and informal employment. There is a need to develop innovative labour market and social protection policies for those working informally beyond the classical social assistance approach.

Based on the review of the evidence on informal work, the following policy and research challenges emerge:

- Improving data collection

Improving statistics and measurement tools to assess properly labour market conditions is crucial for informed policy-making. Section two has shed some light on the poor state of informal labour market statistics and has highlighted the need to improve data collection and quality in the area of labour markets, employment and vulnerability. Existing data sets are scattered, often of a very low quality and out-dated. In particular, regular up-dating and monitoring is missing.

Informed policy decision hinges critically upon knowledge. Once data collection and quality is being taken care of, clear indicators should be constructed and selected to capture the

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realities on the ground[11]. In this, the complexities of informal employment should be well taken into account. For example it should be remembered that often individuals are not either formal or informal but can be both, at the same time or across time. Similarly, it should be taken into account that the individual is not always the appropriate level of analysis, as households or extended families often design strategies together.

- Understanding realities on the ground

There is a need to further analyse the determinants of informal employment and its composition through cross-country studies. Leading questions could be: can we observe a pattern in the size and the composition of informal employment in low- and middle-income countries? What can we say about factors influencing this pattern, e.g. trade openness, labour market regulation, institutional environment and history? What keeps some people excluded from formal employment? What determines individual choices? Some people do not have any choice at all other than staying informal. Besides the poor and the poorly educated, there is emerging evidence that some marginal groups of society are systematically excluded. We need to better understand what holds them away and how we can remedy these bottlenecks. In addition opting for informal employment can be a voluntary choice and people working informally are not necessarily worse-off compared to those working in the formal sector. Hence there is an urgent need to understand better why different groups within the informal sector, such as the self-employed, wage employees, women, men and youth, choose to stay or to go. Finally, it is equally important to undertake a dynamic analysis in order to be able to detect causalities. Of particular interest are the formal–informal linkages as well as the interaction between self-employed and wage employed within informal employment.

- Identifying better policies, instruments and good practices to handle trade-offs: the societal perspective

The focus of this paper has been the individual perspective on choices of informal employment. We therefore have not so much treated the societal perspective, which is of course important from a development perspective. The results of our review offer important insights into how governments and donor agencies may have to change their policies and instruments to better deal with realities on the ground.

Three points seem to emerge: First, there is a need for a holistic assessment of the impact of informal employment on the economy. It is clear that sometimes, from an individual perspective it makes sense to stay informal - but from a societal perspective it is clearly not. To develop a favourable business environment and adequate public services, a certain formalisation of the economy is needed. The critical question here is: how to do it? Many examples show that an aggressive formalisation often leads to the opposite result. It is a very important step forward to identify the right set of incentives through a critical review of good practices and a good understanding of realities on the ground.

[11] The World Bank together with the University of Cornell has started an interesting project to revise and test new indicators and more initiatives of this kind are most welcome.

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Secondly, and following the same line of argument, the more general question is whether the existing policies and instruments of developing countries as well as of donor agencies do take into account the changing and heterogeneous realities on the ground. As an example, it is often not understood that the appropriate unit for risk management is not the individual, but the household or family. Often members of families are allocated strategically between formal and informal employment. This has important consequences for providing the right incentives, for offering appropriate services to informal business as well as for setting-up social protection mechanisms for those in informal employment.

Third, there is a need to differentiate between low-, middle- and high-income countries. In the low income context the formal sector's size is too small so that finding a job there, is for many not a realistic option. The critical challenge here is the transformation of a low labour productivity economy, mostly based on agriculture, to one based on labour intensive manufacturing, and services. In middle income countries the challenges are quite different. Here there is a need to improve formal and informal linkages to create a conducive business environment and to allow for a better social protection of those currently not covered.

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APPENDIX

Table A1: **Description of Variables**

Indicator	**Description**
Loayza and Rigolini 2006	"Share of self-employed in the labour force (as reported in the surveys collected by the ILO)"
Amuedo-Dorantes 2004	Lack of a work contract
Bosch and Maloney 2006	Informal wage workers ("a lack of contributions by the employer to the social security agency") + informal self-employment ("those self-employed and owners of micro firms (less than 6 employees) with no social security contributions, excluding professionals and technicians")
Packard 2007	An "informal sector" consisting of non-contract wage employment, and self-employment
Henley *et al*. 2006	Use of three different definitions: (1) No signed labour card (2) No social security contribution and (3) Employment in firm with 5 or less employees
Gasparini and Tornarolli 2007	(1) Belonging "to any of the following categories: (i) unskilled self-employed, (ii) salaried worker in a small private firm, (iii) zero-income worker. (2) No right to a pension linked to employment when retired.
Günther and Launov 2006	The informal sector ("the active population which is neither employed in the public nor in the private formal sector")

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