



# **Work and Well-Being: Informal employment revisited**

by

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## 1) INTRODUCTION

There is an emerging view in OECD countries that well-being matters as the ultimate goal of development. Fuelled by increasing concerns about environmental degradation, increasing inequality and perceived higher risk exposure by many citizens, the well-established concept for measuring the progress of societies by GDP/GNP changes is increasingly being questioned. While there have been many debates in the past about alternative measures to GDP, it seems that the introduction of the comprehensive “well-being” concept might for the first time seriously challenge the predominance of an income centred view on development.

Interestingly enough, this debate has trickled down to the development discourse (e.g. McGillivray & Shorrocks 2007, Gough & McGregor, forthcoming). Some argue that the concept of “well-being” and “happiness” do not bring any added value to the challenges in poor and middle-income countries. After all, here development is about reducing poverty and not about what some would label “crude fashion concepts” of “well-being”. Empirical evidence seems to suggest that at least at low-income levels, there is a strong correlation between income levels and subjective well-being (Inglehart 2000).

Proponents of the “well-being” agenda are generally not arguing against the fact that raising income is one of, or maybe *the* major condition for improving “well-being”. However, they argue that one needs to go beyond a sole focus on poverty as men and women in the developing world are not solely defined by their poverty status, but are primarily concerned about their well-being like people in the developed world (Gough, McGregor and Camfield, 2006). Even with low income levels, some people in the developing world can still achieve very high self-reported levels of well-being. Moreover, reported levels of well-being still vary enormously for countries with similar low levels of income. For example, ex-socialist societies score dramatically lower than other low- or middle-income countries (Inglehart 2000). Clearly, non-economic aspects matter.

Against this background, this paper uses a “well-being” approach to review literature on informal employment in developing countries. The puzzling finding that informality is on the rise, that sometimes, people in the informal sector are better off than in the formal sector and the debate on the impact of informality on the economy as well as the resulting policy consequences, call for a more comprehensive and holistic approach than has often been applied in the past. Contrary to long standing expectations that in the course of development the majority of workers would move from the informal economy to the formal sector – eloquently analysed in the famous Lewis model – this has not materialized at low- to middle-income levels. Moreover, and more recently, the distinction between “formal” and “informal” occupations becomes increasingly flawed as quite some workers have a footing in both areas. In fact, in many developing and transition countries informal employment has been on the rise.

The objective of this paper is to provide an evaluative literature review discussing opportunities and risks of being employed in the informal sector. Whereas the “risks” are well documented, the benefits and opportunities are not well understood: access to

informal social security, strengthened family relations, flexibility and more autonomy to name a few. This is not at all to deny that many workers would be better off in a functioning formal setting and that there are many risks to staying informal. Important criteria for assessing vulnerability are: “strength of a contract”, “access to benefits”, “level of earnings” and not necessarily if a business is registered or not. We are particularly interested in the relation between formal and informal labour market dynamics and the well-being of workers. Identifying the “appeal” of the informal sector is indispensable for developing incentives to move to a more formalized economy which is in the overall long-term interest of a country’s economic development.

The structure of this paper is as follows. Section 2 discusses some “puzzling” facts related to informal employment that do not seem to be in line with conventional labour market analysis. In particular, informal employment has been on the rise, much in contrast with what traditional economic theory had predicted. Furthermore, although in terms of earnings generally speaking informal workers are worse off, there are important differences and some informal workers can be even better off than formal ones. Building on this, section 3 critically evaluates some existing explanations of informal employment. Additionally, it develops a more comprehensive analytical framework putting emphasis on the various determinants that influence an individual’s decision to work in the formal or informal sector. Finally, the concluding section 4 develops three important areas for future research.

## 2) PUZZLING FACTS ON INFORMAL LABOUR MARKETS

In this section we will present some puzzling evidence on informal employment, which will serve as a basis for our more theoretic discussion in section 3. As the data on informal labour markets need to be handled with caution, before highlighting some of the puzzling evidence, we will first briefly consider some definitional and measurement issues.

### 2.1. Defining informality

In this paper we will not look in depth at issues of terminology<sup>1</sup>, but will provide a short review of what definitions do exist, how the concept of informality is mostly used in practice, and some issues to keep in mind when reading informal employment statistics.

#### *The ILO definition*

The International Labour Office is the main international body providing official definitions of the informal sector and informal employment. The first standardised definition was agreed upon in 1993, where informal work was explained in terms of the production units, i.e. informality in this sense refers to the fact of whether a firm is formal or not. 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.*” 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 (ILO 2002b).

Still, this definition was found to leave out important segments of informal workers, and in 2003 the ILO decided also to include informal employment 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*”. Informal jobs refer to those jobs outside the regulatory framework because they are not subject to labour legislation, social protection, taxes or employment benefits. 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 (Hussmans 2004).

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<sup>1</sup> For a discussion of the terminology of informal employment see ILO 2002a, 2002b; Hussmans 2004; Garparini & Tornarolli 2007; Perry et al. 2007 (chapter 1).

### Definitions used in practice

The two ILO definitions are not extensively used in the broader literature, as they are still quite complex and often data do not cover the dimensions needed to categorise informal enterprises and informal jobs. Instead, more one-dimensional definitions of informality are used, i.e. on the basis of a single variable. The variables chosen, however, vary a lot. Informality seems to mean different things to different people, be it for pragmatic reasons (data limitations) or more intrinsic purposes. As an illustration, see Table 1 below, which lists the indicators used to refer to informality for some recent studies, as well as how some background information for the choice of indicator used (if any).

**Table 1 Informal employment – some indicators used**

Study	Indicator	Background
Loayza & Rigolini 2006	"share of self-employed in the labor force (as reported in the surveys collected by the ILO)"	Authors argue there is "a strong association between self-employment and informal activity, as most self-employed workers tend to be low-skilled, unregistered workers"
Amuedo-Dorantes 2004 Bosch & Maloney 2006	Lack of a work contract Informal wage workers ( <i>"a lack of contributions by the employer to the social security agency"</i> ) + informal self-employment ( <i>"those selfemployed and owners of micro firms (less than 6 employees) with no social security contributions, excluding professionals and technicians"</i> )	Informal employment divided in two main components: wage and self-employment. Informality of wage workers is based on social security contributions; self-employment is informal when it concerns micro-enterprises and lower-skilled individuals.
Packard 2007	An "informal sector" consisting of non-contract wage employment, and self-employment	
Henley et al. 2006	(1) No signed labour card (2) No social security contribution and (3) Employment in firm with 5 or less employees	Authors try to establish difference between three often used definitions. See section 2.2. Informal employment estimates: definition matters
Gasparini & 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.	Authors apply two different definitions, one dependent on the unit of production the worker is employed, and the second based on pension entitlement. See the text below for a discussion.
Günther & Launov 2006	"informal sector comprises the active population which is neither employed in the public nor in the private formal sector"	

As the table shows, very diverse indicators for informality are used. The first definition (Loayza & Rigolini 2006) takes "informal activity" as a starting point, where workers are often low-skilled and unregistered. This is proxied by the share of self-employment in the economy. Some other authors have also used a definition based on the employment category or on the type firm employing the worker. On the other hand, some other indicators are based on the coverage of the worker by a labour contract or social security. These two types of definitions of informality used are sometimes referred to as respectively a 'productive' or a 'legalist' definition (see Gasparini & Tornarolli, 2007).

The *productive definition* takes as starting point the *production unit* where a worker is employed, in the fashion of the 1993 ILO definition of informality. Informality in this sense is conceived of as engagement in marginally productive activities, and normally the type of job is used as an indicator for informality (e.g. self-employed or employment in a micro-enterprises). On the other hand, the ‘legalist’ (or ‘social protection’) definition aims to capture the extent to which workers are covered by labour contracts, social protection and other regulations. The more recent ILO definition on informal employment is more in this tradition as it takes exactly these dimensions as criteria for informality of jobs. Clearly, however, social protection coverage is not the same as having a labour contract or tax payments. For practical reasons, studies normally tend to take only one of the dimensions as criterion for informality. When comparing the legalist definition with the productive one, clearly there are important differences. Note for example that according to the productive concept workers are by definition less productive, but doesn’t necessarily apply to legalist definitions (Gasparini & Tornarolli, 2007).

In conclusion, while some official definitions exist on informality, in practice a variety of definitions is used to describe the phenomenon of informality. As Gasparini & Tornarolli (2007) stress, it is important to remember that the different definitions do not so much represent different views on informality; they rather refer to different *phenomena*. However, they are often all labelled ‘informal employment’; therefore the comparison of the different concepts should be done with caution.

## **2.2. Informal employment estimates: definition matters**

The most common<sup>2</sup> way to estimate informal employment is through household surveys. While in theory they are able to capture several of the dimensions of informality mentioned above, in practice often many dimensions cannot be extracted from the data and as a result, surveys can dictate the definition used by researchers. When comparing informal employment statistics, a number of issues should therefore be kept in mind. First of all, when survey data cannot identify pure informal employment categories, whichever definition is used, most often researchers have to rely on rather imperfect estimates. For example, the share of self-employment is taken instead of informal activity, as for example in Loayza & Rigolini 2006 (see Table 1). Secondly, national statistical offices have not yet standardized their definitions to international standards (where available), survey questions are raised in different fashions and social security systems can be quite distinct. Therefore, international comparisons are often not accurate (ILO 2002a, 2002b,). Thirdly, in case comparisons are made across different definitions, clearly the differences have to be taken into account. Even if the percentages of informality definitions are quite similar, it should be remembered that they can refer to very different groups, between which the overlap is far from perfect.

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<sup>2</sup> 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 a proxy for informal employment through taking the working poor (ILO 2007b, footnote 6).

As an illustration, one study (Henley et al. 2006) investigates 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% to 56% according to the different definitions, these percentages referred to different groups with incomplete overlap. In fact, only 39,6% of the sample could be categorized as informal according to all three definitions (a strict definition). However, according to a broader definition (at least one definition of informality), informal employment would be over 63,6%.

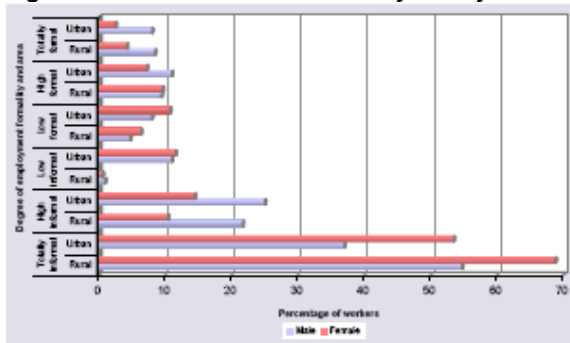
### **2.3. Informality as a continuum**

One way to do justice to the multidimensionality of the informality phenomenon, while highlighting the various degrees of overlap of the different dimensions used, is to present informality as a continuum. A recent ILO report (ILO 2004a) proposed such a continuum with the following five dimensions: regularity status, contract status, workplace status, employment protection status and social protection status. On the basis of these 5 dimensions, people 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, Figure 2 and Figure 3 display the continuum of informality for the Indian state Gujarat, China and three Latin American countries (Argentina, Brazil and Chile). While in Gujarat a large proportion of the workforce is informal according to all five dimensions, and only a very limited share is totally formal, an important share of people are somewhere in between. On the other hand, in China a relatively rather large percentage of people is totally formal, and very few people have totally or high informal jobs. Still the majority of people are in some way(s) informal. In Latin America, a large share of people is not completely informal or formal, but rather somewhere in between.

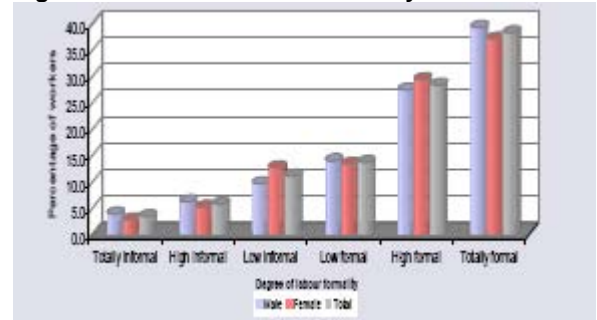
In conclusion, depending on the data available, various measures of informal employment can result. While surveys sometimes dictate a very simplistic definition, sometimes different dimensions can be extracted. However, it should be noted that the ultimate choice (when available) depends on the goal of the research in question as the different definitions refer to *different phenomena*.

**Figure 1 A continuum of informality in Gujarat**



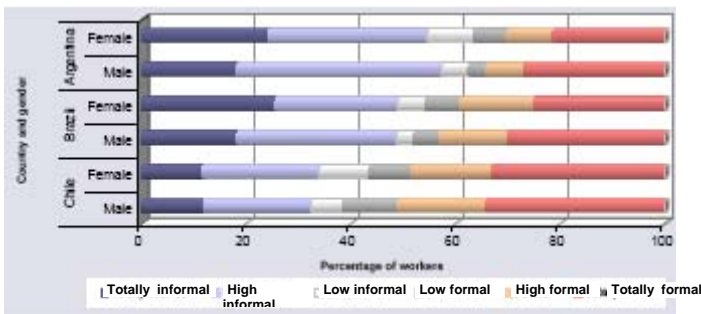
Source: ILO 2004a

**Figure 2 A continuum of informality in China**



Source: ILO 2004c

**Figure 3 A continuum of informality in Argentina, Brazil and Chile**



Source: ILO 2004b

## 2.4. Rising informal employment

When presenting trends in informality we should first of all warn for possible measurement inaccuracies resulting from the issues raised above. More importantly, we should distinguish between different phenomena understood under the label informality.

The ILO has gathered a large amount of information on informal employment in the informal sector, according to its original definition<sup>3</sup>. These statistics are summarised in

Table 2. The resulting picture is clear. First of all, informality differs substantially across regions, ranging in 1980-89 from 38,8% in North Africa, to 68,1% in Sub-Saharan Africa. Secondly, informality according to this definition has increased over time in all regions.

<sup>3</sup> To be precise, it includes all non-agricultural “unincorporated enterprises owned by households”, micro-enterprises, professional, domestic workers, and home-based workers; family labour and “employees on an occasional basis”.

**Table 2 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: Beneria, 2001

Systematic information on informal employment according to a legalistic or social protection definition is not available. Table 3 does however show informal employment for selected Latin American countries according to a social protection definition. To be precise, it displays estimates of the share of workers without social security entitlements, based on household survey data from 1995-2004. While in some countries informality according to this definition has declined or remained stable, in the majority of countries there has been a sustained rise, especially since 2000. More in general, studies tend to confirm a rise of informal employment or at the very least no decline<sup>4</sup>.

**Table 3 Share of salaried workers with no social security rights, selected Latin American countries, 1995-2004**

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
<b>Argentina</b>				37.9%	38.3%	38.5%	38.7%	44.1%	44.9%	
<b>Brazil</b>	38.3%	39.1%	38.0%	36.4%	36.7%		35.9%	36.1%	34.8%	35.0%
<b>Chile</b>		22.0%		22.9%		23.7%			22.4%	
<b>Colombia</b>		74.7%			75.1%					
<b>Ecuador</b>				60.7%					72.2%	
<b>El Salvador</b>				48.5%		47.0%	48.0%	45.4%	48.2%	50.3%
<b>Guatemala</b>						65.6%		59.9%	62.8%	64.9%
<b>Jamaica</b>					74.6%					
<b>Mexico</b>				57.8%		55.0%		59.0%		60.2%
<b>Nicaragua</b>										
<b>Paraguay</b>	69.0%		75.3%		73.8%		72.6%	73.8%	74.4%	76.8%
<b>Peru</b>					77.2%	77.3%	73.2%	71.9%	70.2%	
<b>Uruguay</b>							23.2%	23.7%	25.8%	27.6%
<b>Venezuela</b>	34.6%			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/>.

<sup>4</sup> See e.g. ILO 2004; Perry et al. (forthcoming) for Latin America; Chen Vanek & Carr 2004.

An important question arising from the above evidence is what causes this rise in informality. There are various competing theories concerned with this issue, to which we will come back in the next paragraph. However, a more objective matter studied in this respect 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 (e.g. domestic servants and construction workers, and non-tradables in general) and an increase in the relative share of this sector in the economy would lead overall informality to increase.

Evidence suggests that a large part of the increase in informality observed can be attributed to increases *within sectors*. For example, Bosch and Maloney (2006) find that of a 4% increase in informality in Mexican labour markets from 1991-5, and its return to its original level in 2001, respectively 91% and 90% can be attributed to changes within the sectors. A similar picture arises for most other Latin American countries (Gasparini & Tornarolli 2007)

## **2.5 Composition of informal employment**

Whichever definition is chosen, informal employment generally includes many different types of workers, 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 (see page 5-6). It is not easy to get a clear statistical picture of the size of all these different groups, especially on a global scale. One dimension that is relatively well documented, however, is the extent to which informal workers are self- or wage-employed.

Table 4 displays figures<sup>5</sup> on this for 25 countries across the world. It shows that in all regions self-employment is larger than informal wage employment, but especially in Sub-Saharan Africa. A gender perspective is also very insightful. In some countries self-employment is much higher for women (particularly North Africa). Note also that there is much variation within continents. For example, there is a remarkably low rate of self-employment in South Africa (25% vs. the 70% average). This can be understood as a legacy of the apartheid regime which prohibited blacks from owning their own business (ILO, 2002a).

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<sup>5</sup> These figures are estimations based on the residual method, as discussed in footnote 2. For more information see ILO 2002a.

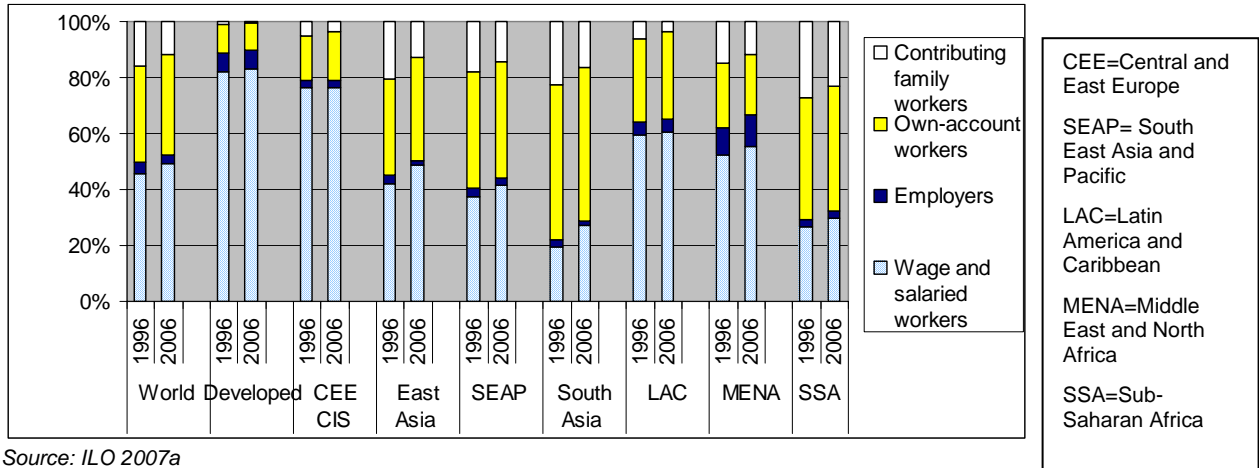
**Table 4 Wage and self-employment in non-agricultural informal employment, by sex**

Country/Region	Self-employment as a			Wage Employment as a		
	Percentage of Non-agricultural			Percentage of Non-agricultural		
	Informal Employment			Informal Employment		
	Total	Women	Men	Total	Women	Men
<b>North Africa</b>	62	72	60	38	28	40
Algeria	67	81	64	33	19	36
Egypt	50	67	47	50	33	53
Morocco	81	89	78	19	11	22
Tunisia	52	51	52	48	49	48
<b>Sub-Saharan Africa</b>	70	71	70	30	29	30
Benin	95	98	91	5	2	9
Chad	93	99	86	7	1	14
Guinea	95	98	94	5	2	6
Kenya	42	33	56	58	67	44
South Africa	25	27	23	75	73	77
<b>Latin America</b>	60	58	61	40	42	39
Bolivia	81	91	71	19	9	29
Brazil	41	32	50	59	68	50
Chile	52	39	64	48	61	36
Colombia	38	36	40	62	64	60
Costa Rica	55	49	59	45	51	41
Dominican Republic	74	63	80	26	37	20
El Salvador	65	71	57	35	29	43
Guatemala	60	65	55	40	35	45
Honduras	72	77	65	28	23	35
Mexico	54	53	54	46	47	46
Venezuela	69	66	70	31	34	30
<b>Asia</b>	59	63	55	41	37	45
India	52	57	51	48	43	49
Indonesia	63	70	59	37	30	41
Philippines	48	63	36	52	37	64
Syria	65	57	67	35	43	33
Thailand	66	68	64	34	32	36

Source: ILO 2002a. Data are for 1994/2000.

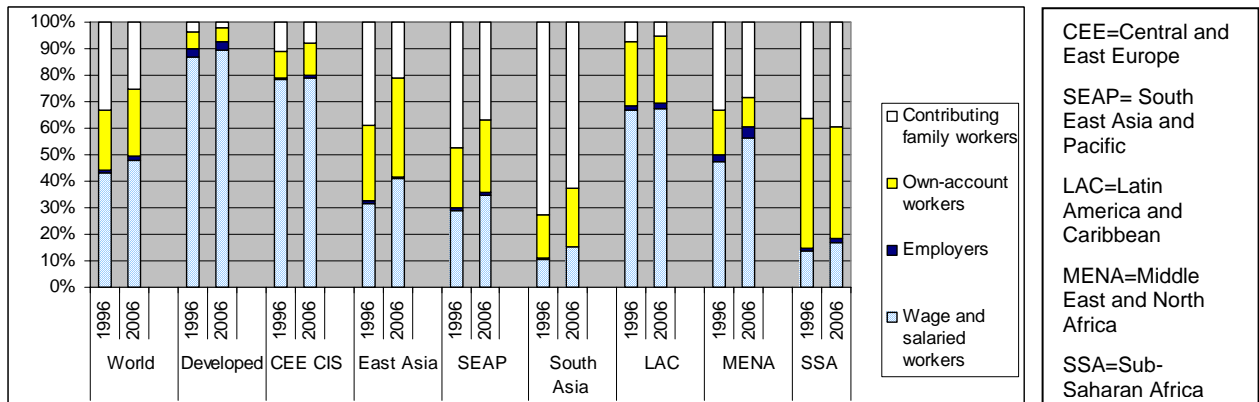
Table 5 and Table 6 display an even more detailed picture on employment categories, as they display contributing family work and own-account work instead of just self-employment. Here, though, informality is not straightforwardly detected. While the last two categories (own-account workers and contributing family workers) are informal according to any type of definition, for the other two categories we can not identify this here. Nonetheless, what is obvious is that contributing family workers but especially own-account workers constitute a very large share (sometimes the single largest) of total male employment. Women are more often contributing family workers. This share is particularly high among women. In addition, we can witness some movements over time. The share of wage employment in total employment has somewhat risen, especially at the expense of contributing family workers. However, the share of own-account workers has also slightly risen.

**Table 5 Employment categories across the world, 1996, 2006 - men**



Source: ILO 2007a

**Table 6 Employment categories across the world, 1996, 2006 - women**



Source: ILO 2007a

## 2.6. The vague line between the formal and informal

It is well-known that many workers often combine formal and informal work; however it is hard to establish the extent of the phenomenon (Chen, Vanek & Carr, 2004).

Table 7 shows for a limited number of countries estimates of informal employment disaggregated along primary or secondary job holdings. In some countries the overlap is quite large. For example 22.5% of informal workers in Russia also have a formal job. In some other countries, this share is much lower.

**Table 7 Primary vs. secondary informal job holding in 5 countries**

	Informal employment as...	
	1 <sup>st</sup> job	2 <sup>nd</sup> 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.

## 2.7. Earnings of informal work

*Earnings relative to the formal sector*

It will come as no surprise that informal employment is generally associated with lower wages than formal employment (Chen, Vanek & Carr, 2004; Perry et al. 2007; Gasparini & Tornarolli 2007; Bosch & Maloney 2006). However, this aggregate phenomenon conceals some interesting particularities. This situation is illustrated with a study on Mexican informal and formal employment (Figure 4). Informality is defined here as a lack of contributions by the employer to the social security agency, and two groups are distinguished: informal salaried and informal self-employed. In

Figure 4 earnings are displayed relative to formal salaried workers. Two things stand out. First of all, at some point in time, earnings of the informal self-employed were actually higher than formally employed workers. For some people informal employment can thus work out quite well. Secondly, relative wages can change much over time. As for the self-employed, their earnings were over 20% higher than the formally employed in 1990, but fell to less than 80% in 1997-8. The same variability applies to the informally employed.

**Figure 4 Relative wage informal / formal sector Mexico 1987-2002**



Source: Bosch & Maloney, 2006

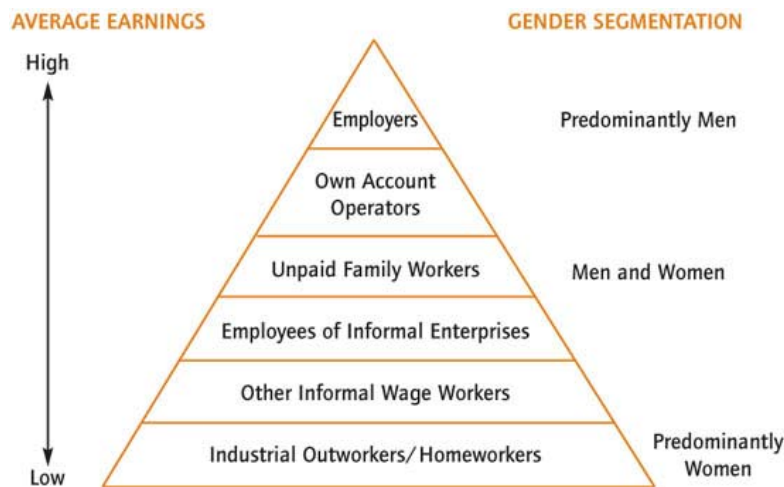
This picture is compatible with other evidence. Other studies also highlight that some informal workers are not worse off than formal workers and that informal employment earnings can vary enormously (Günther & Launov 2006; Maloney 1999; UNIFEM 2005).

*Within informal sector earnings*

From the above it also follows that the relative wages of informal workers differ according to the employment category within the informal sector. Indeed, it is well documented that there are important differences in earnings between the various groups<sup>6</sup>. Chen, Vanek & Carr (2004) propose the following pyramid to describe the earning status of various informal employment groups (Figure 5). While employers can have a relatively good income, some groups such as home workers are much worse off.

The 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 Table 5 and Table 6). What follows is thus also a gender gap.

**Figure 5 Average earnings per informal employment category**



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

<sup>6</sup> See Chen Vanek & Carr, 2004; Perry et al. (forthcoming); UNIFEM 2005; Gasparini & Tornarolli 2007.

## **Conclusions**

As we have seen, no single definition of informality currently exists that is widely accepted in theory and practice. As a result, the concept is still often used in very diverging ways. As we have seen, the resulting pictures of informality can differ dramatically. Nonetheless, the evidence discussed in this section has made some clear empirical points, which present some important theoretical challenges. Notwithstanding the definition used, most of the evidence clearly suggests a rise in informal employment. Finally, evidence on earnings made clear that although generally formal employment is associated with higher earnings, there are wide deviations from this general rules and some segments of the informal labour markets (especially the self-employed) can sometimes actually be better off than formal wage workers. In the next section we will elaborate on the reasons underlying informal employment.

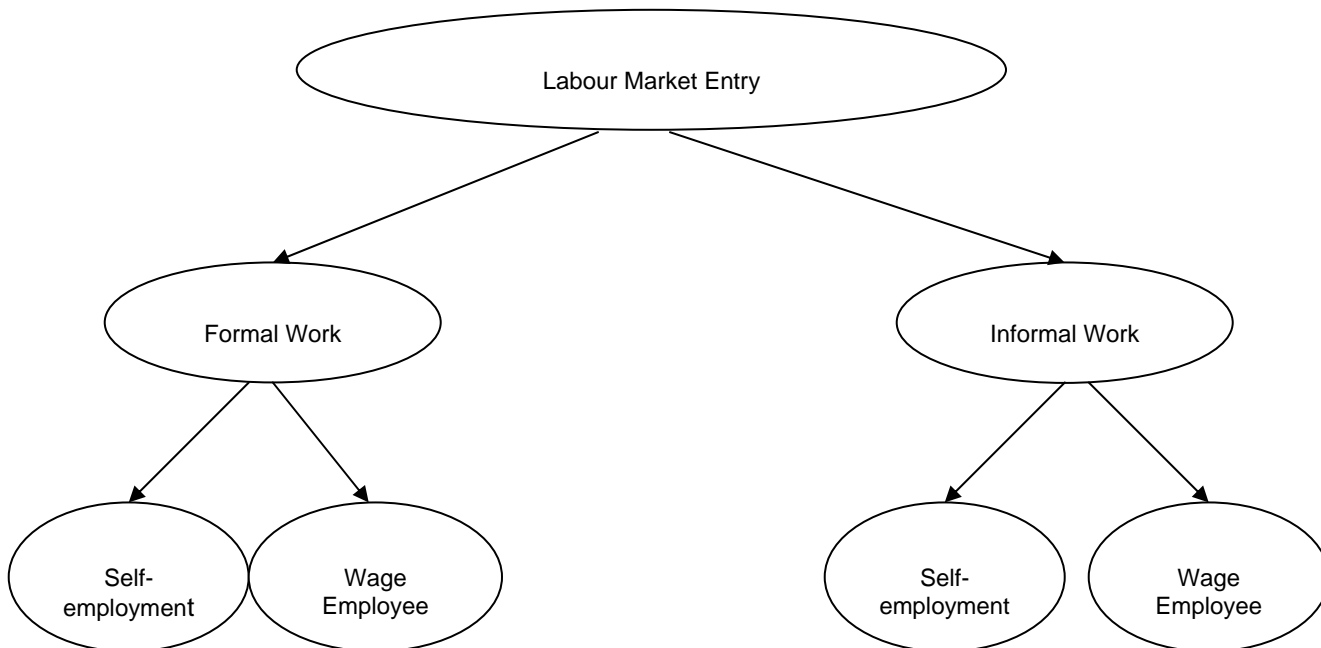
### 3) UNDERSTANDING INFORMAL EMPLOYMENT: TOWARDS A NEW ANALYTICAL FRAMEWORK

#### 3.1. A simple framework of informal employment

A model which has occupied a central position in the debate about informal and formal employment is that of dual or segmented labour markets (e.g. Lewis 1954, Harris & Todaro 1970). Rigidities in the formal sector of the economy lead to the creation of a second, informal sector of work, which attracts many of those who cannot get a formal job. Segmented labour markets may be further related to barriers to labour mobility, efficiency wages etc. Individuals working in the informal sector would have preferred to work formally, but are rationed out due to labour market segmentation. Hence the informal sector is described as a sector of exclusion or a sector of last resort for individuals with low skills and weak prospects of finding jobs in the formal sector.

The simple conventional framework of labour market selection (including informal work) is shown in Figure 6. Once the decision to enter into the labour market is taken, individuals are selected in formal or informal employment. In a second stage, a choice of the type of employment is made. In a simplified way, this is a choice between a salaried job and self-employment.

Figure 6: A simple conventional framework of labour market decisions



### **3.2. Challenging the conventional model**

The previous section has provided recent evidence which challenges the 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 & 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, may be needed.

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 make workers choose informal employment (Saavendra and Chong 1999). 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 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 weight 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. Maloney (2004) uses data from Latin American countries and provides evidence that about 60% of people in informal self-employment left their previous jobs and engaged in self-employment in a voluntary manner.

However, not all people in the informal sector are there by choice. In fact 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. (forthcoming) 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. However, Perry et al. 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 (Table 8 provides a short summary of the evidence in the literature). Young workers are mostly found to work as informal paid workers and this is especially true for the less educated ones who have no chance of getting a job in the formal sector (Saavendra and Chong 1999). Older workers are often self-employed in the informal sector. They may be more willing to switch to 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 (social protection etc.) 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 in the sector.

**Table 8: 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		+	+
Poverty			+
Firm size	+	-	-
Sector		Construction, transport, agriculture, trade	Construction, transport, agriculture, trade, services

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. Recent evidence (Perry et al., forthcoming) shows that single women are the most likely group to be in formal employment relative to married women and men. 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 & 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.

Education is an important factor determining selection into the formal or informal sector. Individuals with no, or minimum education are mostly wage employees in the informal sector. Some of the highly educated find employment in the formal sector whereas others become self-employed in the informal sector (Saavendra and Chong 1999). 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 leave for the informal sector (Maloney 2004). 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 job in the formal sector. However, for unskilled and disadvantaged young individuals, the main entry point into the labour market remains the informal sector. They stay there, often changing employers, until they accumulate the necessary savings, and possibly human capital, to move to self-employment.

### **3.3. Costs and risks associated with work in the informal sector**

Work in the informal sector 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. Work in the informal sector may be related to chronic poverty (the chronic poor). The costs and risks associated with informal sector work are summarised in Table 9 and can be classified in four main groups of costs and risks in informal work:

- **Uncertainty and vulnerability:** Informal work is characterised by higher uncertainty in terms of income flows as well as informal contract renewal and may be associated with higher unemployment risk (Duryuea et al. 2006). Informal activities are often seasonal and thus dependent on weather conditions and natural disasters.
- **Lack of benefits:** 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 etc. An ILO study (Lee 1998) shows how employment insurance would have cautioned workers against falling into poverty in the Asian financial crisis.
- **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 satisfied. Besides, informal sector employees have less chance of accessing formal training.

- 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 in terms of bribes etc.

**Table 9: Costs and risks associated in 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)	✓	

### 3.4. Benefits and opportunities of working in the informal sector

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). 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 sector employment a better option for some people (Maloney 1999). The benefits and opportunities offered by informal employment can be summarized in the following categories:

- Higher pay: individuals with specific characteristics may have a comparative advantage in informal employment. This comparative advantage may 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. Working from home may be very interesting for women in some countries, when their physical mobility is constrained by social norms.
- 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, there is uncertainty about the payment of future pensions etc. 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).
- 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, e.g. the ‘lighthouse effect’ in Brazil. 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 may provide 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. Besides, 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.

**Table 10: Benefits and opportunities in 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 etc)	✓	✓

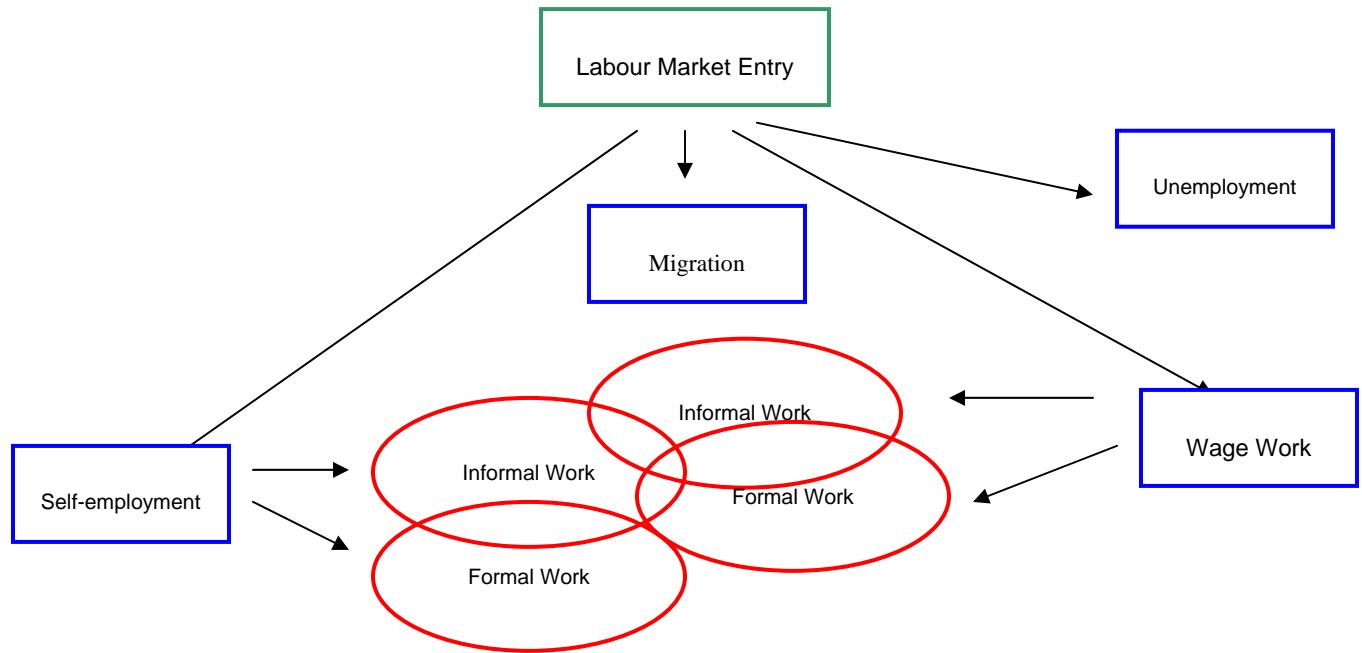
### 3.5. Towards a more complex framework of informal employment

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 as it was presented in Figure 6. 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. Given the complexity of the issue and the vast variety of possible types of informal activities and employment, the simple framework presented earlier is not likely to fully capture the selection of individuals across the different types of employment.

First it is important to add migration into the picture. Migrating within the country or abroad is a common and increasingly used strategy to cope with risk and increase household income. For that reason it should be included in a framework showing the labour market decisions made by individuals. 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 6, 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.

Figure 7 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 occupation and activity of the respondent.

**Figure 7: Elements of a revised framework of labour market decisions**



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.

#### **4) AN EMERGING AGENDA: POLICY AND RESEARCH CHALLENGES**

The primary objective of this paper is to discuss opportunities and risks of informal employment. Informal employment is broadly on the rise and there is an urgent need to better understand the drivers of this development. The dynamics of informal employment, its components – wage employees and self-employed - and the change within this composition has a huge impact on the pattern of growth a country is taking as well as how access to social security can be organized and funded. A major finding of the critical evaluation of the literature is that the current realities no longer match with longstanding models of development, challenging the conventional wisdom.

As a starting point, the benefits often associated with being employed in the formal sector – access to social security benefits, job security, higher wages and earnings, etc. – are increasingly seen as by no means certain or given. Many factors have contributed to this loss of attraction: the downsizing of the public sector, low quality or no provision of social security; the informalization within the formal sector etc. All this has rendered formal employment less attractive. Interestingly, the opposite side of the coin also seems to undergo changes: there is emerging evidence that working or being self-employed in the informal sector is not that bad after all. The long-held view associating “informal employment” with low paid jobs, exclusion, low quality of work etc. seems not to match with reality. Besides the well known arguments of tax evasion, higher earning potential and less regulatory constraints for the self-employed, this study also finds ample evidence that informal workers might also benefit: access and strengthening of family networks and thereby producing and using social capital; more flexibility and often a less risky way of achieving income. This is not to say that most informal workers wouldn't be better off working in the formal sector – if one exists. It can be argued that the poor working in the informal sector have simply no choice at all. But this review has challenged this common perception – many people have indeed a choice within informal employment activities but unfortunately too often these choices are not real opportunities for escaping poverty. To cope with this situation many have a footing in both – in formal as well as in the informal part.

The following policy and research challenges emerge from the review:

##### **1) Understanding better the realities on the ground**

There is a wide consensus that the size and the composition of informal employment varies substantially across countries, within sectors and changes are quite dynamic and seem to have accelerated over the last years.

There exists a large agreement that there is a need to improve data collection and quality in the area of employment. Existing data sets are scattered, often of a very low quality and out-dated and in particular regular up-dating and monitoring is missing. Improving

statistics and measurement tools – in particular indicators – to assess properly labour market conditions is crucial for informed policy-making.

Besides improving data and statistics, there is a need to analyse in depth the determinants of informal employment and its composition through cross-country analysis. Leading questions could be: Can we observe a pattern between low and middle income countries regarding the size and the composition of informal employment? What can we say about factors influencing this pattern – e.g. trade openness, labour market regulation, institutional environment and history?

Third, and equally important, is to undertake a dynamic analysis. In order to be able to detect causalities the time dimension needs to be added. Of particular interest is the formal – informal linkages as well as interaction within the informal employment sector between self-employed and wage employed.

## **2) Understanding better individual choices**

This evaluation of the literature has shown that the conventional thinking on people's perception vis-à-vis informal employment is flawed. To opt for informal employment can be a voluntary choice and people are not necessarily worse-off compared to those working in the formal sector. There is an urgent need to understand better why different groups within the informal sector choose to stay or go: self-employed, wage employees, women and men, youth, etc. A critical question, of course, remains for those who have apparently no choice at all other than staying informal: besides the poor and un-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.

## **3) The societal perspective: Identifying better policies, instruments and good practices to handle trade-offs**

The focus of this paper has been the individual perspective on informal employment. We thereby have not 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.

Two 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 for many reasons from an individual perspective it makes sense to stay informal – but from a societal perspective it is clearly not. To develop a conducive business environment and public services a certain formalisation of an economy is needed. The critical question here is: how to do it? Many examples show that an aggressive formalization often leads to the opposite result. To

identify through a critical review of good-practices the right set of incentives is a very important step forward.

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 developing appropriate services to informal business as well as to setting-up social protection mechanisms for those in the informal sector.

To conclude, the above three mentioned areas of future challenges for policy and research are only a selection of what potentially can and should be done. It is very timely to start to do it now, as with increasing evidence we are better able to more precisely describe and understand what is happening and then are hopefully also able to meet the challenge to develop productive and good jobs for the benefit of the whole society.

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