



Is Informal Normal? Toward More and Better Jobs

Is informal employment normal?

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Introduction

The financial and economic crisis that began in 2008 has far-reaching implications for employment around the world. The slowdown in economic activity can be expected to raise unemployment, reduce international labour mobility and lead to an increase in informal employment. These developments will critically affect poverty levels and income distributions.

Informal employment refers to jobs or activities in the production and commercialisation of legal goods and services that are not registered or protected by the state. Informal workers are excluded from social security benefits and the protection afforded by formal labour contracts. The majority of them cannot opt for scarce better jobs in the formal sector. Others voluntarily opt out of the formal system. For them, the savings from being completely or partly informal – no social security contributions, no tax payments, no binding labour regulations, and more freedom for business activities – outweigh the benefits accrued through registration and compliance. The prevalence of informal employment in the developing world is striking. Even before the current crisis, over half of non-agricultural jobs there could be considered informal.

The share of informal employment activities tend to increase during economic turmoil, since informal work can act as a buffer when people are laid off in the formal sector. Despite offering a fallback option to sustain livelihoods, informal employment comes at a cost. First and foremost, informal work is vulnerable. In times of crisis, informal workers are exposed to a likely depression of wages due to the inflow of laid-off workers from the formal sector and return migrants. They are also the first to lose their jobs. Second, the potential increase of informal employment locks workers into vulnerable situations. Lack of formal social protection in the face of health and occupational risks, and no protection of labour rights, puts many informal workers at a higher risk of poverty that they would otherwise be and might substantially increase poverty levels.

This *Policy Brief* examines the phenomenon of informal employment and its impact on individuals and society, particularly in the context of a global economic downturn. ■

Is informal employment normal?

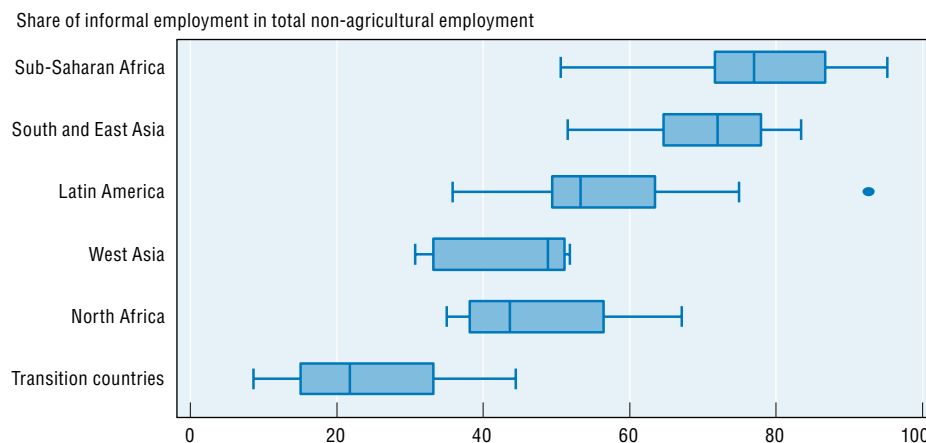
Informal employment is the norm, not the exception, in many parts of the world: More than half of all jobs in the non-agricultural sectors of developing countries – over 900 million workers – can be considered informal. If agricultural workers in developing countries are included, the estimates rise to some two billion people. Informality is thus a reality for two-thirds of the global labour force. In some regions, including sub-Saharan Africa and South Asia, over 80 per cent of non-agricultural jobs are informal. On top of this, the majority of agricultural jobs are also informal, including those of self-employed farmers as well as the great majority of day and casual labourers.

When informal employment was first acknowledged in the 1970s, discussions on the subject focused on a small set of low-income countries. Inefficient public institutions, cumbersome registration processes and a general distrust of the government – all factors that spur the creation of a market outside a country’s formal structures – were seen as the sure signs of underdevelopment. It is often assumed that these factors, and hence informal employment, would disappear in the course of economic development.

The reality does not warrant such optimism. Informal work is increasingly the norm, not least in middle-income countries, and it is sizeable even in some high-income countries. In some cases, the share of jobs performed outside a country’s formal structures may be more than half of all non-agricultural jobs, and up to 90 per cent if agricultural jobs are included. The prevalence of informal employment has stagnated and even increased despite economic growth. In Southeast Asia and Latin America, on average, economic growth over the past 20 years was accompanied by increasing, not falling, rates of informal employment.

Most informal workers in the developing world are self-employed and work independently or own and manage very small enterprises. Informality is often a means to lower labour costs. As a response to greater international

Figure 1.
SHARE OF INFORMAL EMPLOYMENT IN TOTAL NON-AGRICULTURAL EMPLOYMENT



Note: The box chart shows the range of informal employment as share of total non-agricultural employment by region, based on the latest available observation for each country. The edges of each box correspond to the upper and lower quartiles, with the vertical line inside indicating the median value for each region. The ‘whiskers’ outside the box show the upper and lower adjacent values of the data. The outlier value in Latin America is Haiti.

competition and an unaffordable business environment, some statutory protections for workers in the formal sector, including in some OECD countries, might begin to be whittled away, creating, in effect, an informal work force. For example, in what has come to be known as false self-employment, individuals sub-contract themselves every day to the same employer – voluntarily or not – and thus operate as self-employed contractors in order to bypass the legal requirements of a normal working relationship. ■

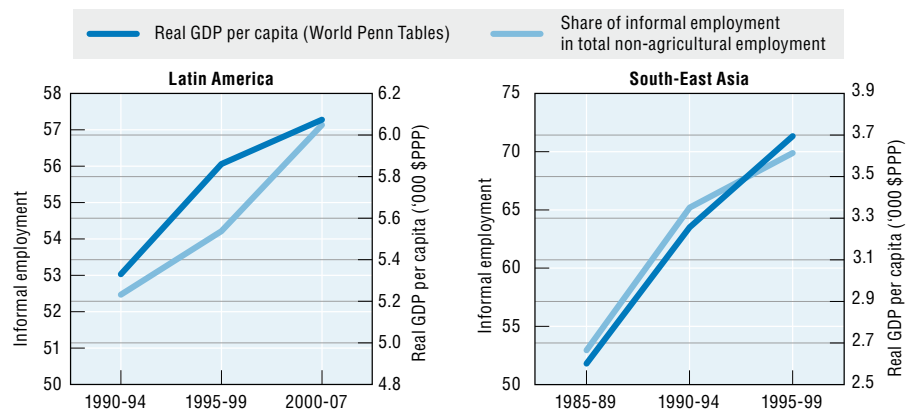
Why do people work informally?

There are various types of informal employment, which makes it difficult to assess this complex phenomenon. Levels of informal employment vary widely across countries, reaching the highest shares in sub-Saharan Africa, where close to 80% of all employed people work informally, followed by Southeast Asia and Latin America.

Informal employment can be a result of both people being excluded from formal jobs and people voluntarily opting out of formal structures. In many middle-income countries, for example, incentive structures drive individuals and businesses out of the formal sector. In Latin America, formal workers are often required to pay for a mandatory bundle of benefits, some of which they do not even want. Likewise, many businesses opt out of the formal structure because inefficiencies in business registration and social security administration inflate the costs of remaining in the formal economy.

Economic development also plays an important role in determining the prevalence of informal employment. Episodes of rapid economic expansion often coincide with sharp increases in informal work. However, sustainable economic development can help to reduce levels of informal employment. Long-term, increasing per capita income, for example, is clearly associated with lower levels of informal employment.

Figure 2.
INFORMAL EMPLOYMENT AND GDP IN LATIN AMERICA AND SOUTHEAST ASIA



Source: Based on un-weighted averages of countries in *Is Informal Normal? Toward More and Better Jobs*, OECD, 2009.

But informal employment is not merely a facet of underdevelopment that holds economic growth down. In some countries, the use of informal channels may indeed have positively affected economic development. If cumbersome registration procedures and other administrative red tape undermine the creation of formal businesses, for example, informal working conditions may help to encourage entrepreneurial behaviour. A good example of this is found in South Africa, where, by avoiding formal structures, such as route concessions, licence requirements and safety regulations, entrepreneurs have created a multi-million-dollar business in mini-buses.

In other instances, the use of informal structures may be driven less by a voluntary decision than by necessity. For many people, informal employment is an important livelihood strategy and plays a critical role in alleviating poverty and social hardship. However, informal work leaves people without adequate social protection and traps them in unproductive and precarious jobs. In these cases, the lack of formal structures is a reason for, not the solution to, lagging economic development. ■

What problems are associated with informal work?

Many people depend on informal employment for a living, but informal work has serious consequences for both individuals and society. Beyond earning levels, informal employment makes basic rights vulnerable and difficult to defend. As such, it can be a major cause of poverty in other ways besides income. Most of those who work informally are insufficiently protected from the various risks to which they are exposed: illness or health problems, unsafe working conditions and possible loss of earnings. This is particularly important for the poor, whose labour is by far their most significant asset.

For society as a whole, pervasive informal employment undermines the ability of the state to ensure that workers have fair working conditions, including appropriate working hours and safety regulations, and that they receive adequate pay. Persistently high levels of informal employment reduce fiscal revenues and the ability to develop social security systems based on taxes and contributions. They also imply an inadequate use of available human resources as informal jobs are believed to be associated with a loss of efficiency and productivity.

In addition, the size and composition of informal employment influence the growth pattern of an economy. It is unclear whether or not informal employment represents a drag on productivity or could, at least temporarily, be an engine of growth. For example, many observers argue that a high degree of informal employment may reduce the competitiveness of an economy, since informal firms prefer to stay small, have less access to inputs, and cannot engage in formal business relationships, all factors that reduce their productivity. Others emphasise that in emerging economies, such as China, informal employment allows the necessary flexibility to produce innovative entrepreneurs who boost growth. Whatever the validity of these two opposing views – small firms characterised by low-productivity vs. innovative entrepreneurs with high levels of flexibility – it is widely accepted

that informal employment is an important issue to which policy makers must respond. ■

Is informal employment linked to poverty?

In spite of its growing importance even in some OECD countries, informal employment remains particularly problematic in developing countries. The majority of the 1.7 billion poor living on less than two dollars a day depend almost exclusively on their labour for survival, emphasising the importance of employment for poverty reduction and economic development.

A general lack of formal employment and the limited coverage and effectiveness of social security systems imply that the poor often have to undertake any type of work simply to sustain themselves and their families. Dismissed workers frequently have to accept the first available job, even if it is of a lower quality than the one they have just lost.

Certain groups, such as young people and women, require specific attention, as they are over-represented among the informally employed. Women seem to be disproportionately involved in the most vulnerable forms of informal employment. Until recently, researchers and policy makers concentrated chiefly on gender differences in labour-market participation and the barriers that women face in employment. Although this remains an important concern, a second aspect of labour-market outcomes should be added: gender differences in the quality of jobs and inequality of access to good, secure and well-paid jobs. Understanding why women are over-represented in informal work is of primary importance for designing more effective policies that allow a country's workforce, including women, to engage in productive activities.

Even though informal employment is pervasive in many low and middle-income countries, it is not an acceptable foundation for sound and sustainable development. However, simply abolishing micro-enterprises or informal wage work is not a viable policy response. On the contrary, such measures would result in significant social costs and represent a huge challenge for public expenditure. ■

How can we address the challenges posed by informal employment?

Despite the fact that informal employment can be a shock-absorber in times of economic crisis, it is not a substitute for policies addressing the increased risk of poverty in the current recession. Informal work does offer temporary job prospects, but a rise in the level of informal employment would not be good news for developing countries. Given its association with low-quality, high-risk jobs and insufficient social protection, a growing informal sector might well be accompanied by a substantial increase in the level of poverty in a country.

Still, informal employment can be expected to influence labour markets for many years to come. Governments should face this reality and incorporate this understanding into their policy making. Many reforms in the past have failed to deliver successful results, largely because they were not specifically targeted to the different types of informal work that exist. It is important

to find the right balance between guaranteeing social protection for those who are excluded from formal structures and encouraging those who have voluntarily left the formal sector to return to it. The focus of policy interventions should rest on providing jobs that are more productive and offer adequate social protection.

Mainstream policy recommendations remain part of the necessary policy mix. Macroeconomic stability, structural policies aimed at creating formal jobs and easing mobility, and poverty-alleviation policies that provide risk-management and social protection for the poor are desirable. But business-as-usual will not do. Linking employment, growth and poverty-reduction also requires providing tools to reduce risk for those informal workers in danger of falling into poverty and easing mobility between formal and informal work.

The first step toward reducing levels of informal employment is to reinforce the advantages of working in the formal sector. People who have chosen to leave the formal sector must be given incentives to rejoin it. Benefits should be linked to social contributions, while administrative procedures, such as business and workers' registration, should be simplified. Apart from positive incentives, reducing informal employment also requires strengthening enforcement mechanisms. However, policies need to address those who have no choice but to work informally. These people need a different approach from those who voluntarily opt out of the formal sector. Poverty-alleviation programmes can provide some assistance to those whose options for entering the labour market are limited. Sustainable poverty-reduction also requires interventions to increase the earning capacity of informal workers.

A better understanding of the complexity of informal employment and a more nuanced approach to addressing the specific needs of informal workers are urgently needed. Informal employment comprises different phenomena that require distinct policy approaches. A critical first step is to identify the types of informal employment present in each particular country. A three-pronged strategy can then be adapted to the specific situation in a country:

1. For the world's poor, working informally is often the only way to participate in the labour market. Policies should thus try to unlock these people from their low-productivity activities, enable them to be more productive and provide them with opportunities to climb the social ladder. Specific recommendations include active labour-market policies, such as training and skill-development programmes, that re-open the doors to the formal sector.
2. If informal employment is a deliberate choice to avoid taxes or administrative burdens, governments should aim to establish efficient formal structures that encourage people to join or rejoin the formal market. Countries should aim to introduce formal structures that can offer the same, or higher, levels of the flexibility and efficiency that informal channels may provide. In this way, informal workers, who frequently have strong innovation and growth potential, can more effectively contribute to a country's overall competitiveness. Targeting those who voluntarily opt out of the formal sector also involves establishing credible enforcement mechanisms. This entails

spending more resources on labour inspections, for example, that will help identify law breakers and increase compliance with a country's rules and regulations.

3. In many low-income countries, informal employment is mainly a consequence of insufficient job creation in the formal economy. While employment levels in the world have largely followed the growth in working-age populations, there is a need for a general push for more employment opportunities within the formal sector. Governments should support small businesses in complying with formal requirements and encourage large companies to create formal employment opportunities.

Targeted policies can do much to reduce the level of informal employment in a country, but they are no substitute for trust. A thriving informal sector is, above all, an expression of a lack of trust in public institutions, a negative perception of the role of the state, and limited understanding of the benefits derived from social security. It is basically a sign of a broken social contract. Restoring that contract requires a change in people's attitudes and beliefs. More innovative policies, such as information campaigns on the benefits of formal work and the risks of informal employment, can prompt that kind of change. ■

For further information

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For further reading

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