Introduction: What Sustains Informality?

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ABSTRACT This paper provides an introduction to a special issue on what sustains informality. The papers in the special issue contribute significantly to critical issues related to the nature of informal employment and its determinants, how informal firms can grow their business and productivity, and the effects of labor market regulations and social insurance policies on informality.

KEYWORDS: Informality; developing countries; productivity; labour regulations; social insurance policies

1. Introduction

Informal employment is widespread in developing countries, constituting more than 60 per cent of total global employment (Chen & Carré, 2020). In Africa, for instance, every 8 out of 10 work informally (ILO, 2018). Micro, small, informal and mostly household-run enterprises employ a large share of the workforce and provide livelihoods for the poor (La Porta & Shleifer, 2014). Women, in particular, are more likely to engage in precarious forms of informal work, such as contributing family/unpaid workers in the enterprises headed by the males in their households, or in poorly paid casual jobs in the informal sector. Pervasive informality is particularly widespread in sub-Saharan Africa and South Asia, and less so in East Asia and Latin America, whether informality is defined as a lack of firm registration, lack of social security coverage or lack of an employment contract (World Bank, 2021).

Why do we see the persistence of informal employment, in spite of rapid economic growth in many parts of the developing world? What are the factors that may explain the pervasive informality that one observes in low- and middle-income countries? How can informal firms grow and what can be done to increase the productivity of informal enterprises? How do public policies contribute to reducing informality and what should policymakers do to promote decent and remunerative work for such workers?

Focusing on a range of developing countries (covering Asia, Latin America, North Africa and sub-Saharan Africa), the papers in the special issue seeks to provide a better understanding of the drivers that cause individuals to engage in informal employment, exploring elements of choice and compulsion as well as contextual factors. In addition, the papers in the special issue...
provide guidance on how to make informal enterprises grow, and how to design policies that increase the formalization of informal firms and workers. Specifically, the papers contribute significantly to critical issues related to:

1. **What is the nature of informal employment, and what are its determinants?**
2. **How can informal firms grow their businesses and increase productivity? What factors promote firm performance and entrepreneurship, and formalization?**
3. **What are the effects of labour market regulations and social insurance programmes on informal workers and households?**

### 2. Understanding the nature of informal employment

A key issue concerns the persistence of informality in the labour markets of many low- and middle-income countries, despite rapid economic growth in recent decades (Kanbur, 2017). While informal employment has primarily been portrayed as providing a source of livelihood for the poor (La Porta & Shleifer, 2014), the extent of heterogeneity within informal work is increasingly being recognised (see, e.g. De Vreyer & Roubaud, 2013; Grimm, Knorringa, & Lay, 2012; Perry et al., 2007; Radchenko, 2017). Three papers in the special issue investigate the nature of informal work and the factors that may have contributed to its persistence.

Churchill & Danquah (2022) demonstrate that in addition to economic and institutional factors commonly considered in the literature, socio-cultural factors play an important role in explaining the prevalence of informality. Their work examines how ethnic diversity influences informal work in Ghana. Using panel data from two waves of the Ghana Socioeconomic Panel Survey, the authors find that ethnic diversity is associated with a higher probability of engaging in informal work. They associate this with lower levels of trust in ethnically diverse communities, arguing that trust plays an important role in reducing the probability of engaging in informal work.

To understand the persistence of informal work, Conover et al. (2022) characterize the labor market status and transitions among young, male, urban workers in Mexico. They contribute to the informality literature by documenting how path dependence of informality affects early labour market entrants. Using the nationally representative rotating labour force survey, the authors characterize workers in three job types: formal salaried, informal salaried and self-employed (99% of whom are informal), and investigate the benefits or costs associated with shifting between jobs. Better educated workers are more likely to attain and keep formal jobs and experience greater wage increases from transitioning out of informal into formal wage employment. Meanwhile, transition rates into self-employment are similar across education levels and wage benefits are highest in the middle of the education distribution. They conclude that self-employment can present a sector of opportunity, but not for all.

Hernández (2022) sheds more light on whether the large share of informal employment in developing countries is mainly attributable to a lack of otherwise preferable opportunities in the formal economy, or whether this sector is formed by workers who voluntarily seek this type of employment given the incentives in the market. The author uses a special supplement of the 2015 Mexican Labour Force Survey which directly asks urban workers about their valuation of jobs with social security coverage. He indicates that a large fraction of the urban informal workers in Mexico is not voluntarily so. The discussions in the paper highlight two main factors that limit the number of workers employed in formal jobs. The first is related to household demographics and the division of housework. The second is related to human capital, as higher levels of schooling increase the chances of being hired informal jobs and of obtaining higher earnings in them.
3. How can informal firms grow?

Many policymakers in developing countries face a difficult policy dilemma on what can be done to boost the outputs of the many informal firms. The papers in the literature examining how informal firms can grow and increase productivity have largely focused on access to finance and quality infrastructure, and formalization among others (see Aker & Mbiti 2010; Boly, 2018; Campos, Goldstein, & McKenzie, 2018; Nichter & Goldmark, 2009). With respect to access to finance, there is little and less consensus in the literature on the importance of credit access on the performance of small enterprises (Nichter & Goldmark, 2009; Woodruff & Zenteno, 2007). Also, the conclusions of the few studies on formalization and firm productivity have been mixed (Benhassine, McKenzie, Pouliquen, & Santini, 2018; Boly, 2018; Campos et al., 2018). Three papers in the special issue address the question of how informal firms can grow and increase their productivity.

Berkel & Tarp (2022) use a novel panel survey of enterprises in Myanmar to investigate the relationship between four categories of formalization (local, national, tax and social security) and firm productivity. They show that the only formalization category that appears to be significantly associated with productivity is tax formalization. This positive association only holds for firms that were already more productive and bigger before formalizing than other informal firms. The reason for the insignificance of the remaining three categories is likely to be the insignificant association between formalization and potential benefits of formalization such as more access to credit, employees and investments. High taxes and fees linked to formalization seem to outweigh the few to non-existent intermediate benefits of formalization.

Gang et al. (2022) focus on the role finance/credit/banking access plays in expanding informal sector enterprises beyond family and household units. Using nationwide data collected in 2010–2011 and 2015–2016 by India’s National Sample Survey Organisation on unorganised (informal) enterprises, the authors show that lack of access to finance constrains the transition of firms within the informal sector in India. This effectively means that, as the constraint weakens, firms are willing and able to expand hiring beyond family workers. However, the authors do not find clear gender differences in transition with the easing of finance constraints: female entrepreneurs are no more likely to join the entrepreneurial side of the sector than male entrepreneurs.

Mishra (2022) develops a theoretical model that considers two vertical links between the informal and formal sector firms and studies their implications. The author models a situation where final products produced by the formal and informal sector firms are vertically differentiated in terms of quality and consumer demand for the informal sector firm is related to the distribution of income. Less well-off consumers generate demand for the low-priced, low quality good produced by the informal sector. The paper, therefore, shed more light on the implications of this quality choice for the size of the informal sector.

4. The effects of labour regulations and social insurance policies on informality

Governments in developing countries use a range of policies to address poverty and inequality. One set of policies addresses inequalities in labour markets, by providing protection to formal sector workers through regulations that make it difficult for employers to fire workers, especially in face of negative demand shocks that may accompany the opening up of the economy to international trade. The second set of policies that are especially targeted toward informal workers provides social insurance programmes to such workers to protect them against risks, particularly those associated with illness, death, disability, longevity and loss of employment (Levy, 2021). Relatively little is known about the effects of labour market regulations and social insurance programmes on informality, and whether such policies protect the vulnerable sections of the workforce as intended (Bastagi et al., 2019, Dix-Carneiro, Goldberg, Meghir, & Ulyssea,
Two papers in the special issue examine the effects of labour regulations and social insurance programmes on informality, with a focus on Latin America.

Employing data from the Brazilian decennial Census, Almeida et al. (2022) examine the impact of labour market regulations on informal employment status, in the aftermath of a trade shock. The paper finds that while positive trade shocks as captured by exchange rate depreciation led to a decrease in informal employment, the positive effects of the trade shocks on formal employment were less evident in Brazilian municipalities that strictly enforced labour regulations. The authors find that flexible labor market policies may in fact protect workers and help the transition to the formal economy in the aftermath of employment shocks.

Canelas & Niño-Zarazúa (2022) investigate the effects that social insurance policies have had on the Bolivian labour market. The specific policy they study is the Renta Dignidad, a universal non-contributory old-age pension. The authors take advantage of a natural experiment in the country – the change in the legal coverage that resulted from a policy reform that reduced the pension’s age eligibility from 65 to 60 years. The results suggest that access to the Renta Dignidad transfer had no effects on individuals’ labour force participation or hours worked. However, the pension increased the incidence of self-employment among household members of working age living with pensioners in rural areas, leading to a shift from formal waged employment to informal self-employment.

5. Conclusion

The findings of the papers in the special issue have three broad implications for our understanding of what causes informality. Firstly, the factors that explain the presence of informality or the limited movement into formal jobs are not only economic in nature, such as lack of human capital, but also encompass social factors such as levels of trust and division of work in the household. Secondly, greater access to credit and reducing taxes and fees for the smaller formal firms may allow for higher growth of informal firms, or make it more likely that they will formalize. Finally, well-intentioned public policies such as strict labour regulations for formal firms and non-contributory social insurance policies can contain or exacerbate existing pervasive incentives for informal employment, leading to unintended consequences.

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