Persisting Informal Employment: What Explains It?

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Presentation Overview

I. Formal-Informal Employment Dynamics and Economic Growth
   - Informal employment and growth patterns
   - Theoretical foundations
   - New developments: Forms of informal employment that can be complementary with economic growth and globalization

II. The Effect of Labour Regulations on Informal Employment
Cross-country patterns suggest that the share of informal employment declines alongside economic growth…
...Yet in recent years, informal employment has persisted in the face of economic growth
Why does informal employment persist?

Theoretical foundations

• Harris-Todaro (1970) versus Lewis (1954) Models of dual labour markets for developing countries
Most models of formal-informal employment dynamics are based on the Harris-Todaro Model

“The distinguishing feature of this model is that [rural-urban] migration proceeds in response to urban-rural differences in expected earnings…with the urban unemployment [i.e., informal employment] rate acting as an equilibrating force on such migration.”
Paradox:
In the Harris-Todaro model, more formal employment and urbanization result in more informal employment

Two-fold policy package:
1. Restrictions on rural-urban migration and/or rural development
2. Limited wage subsidies and/or direct employment by governments

Emphasis on rural poverty and development
Dilemma for Harris-Todaro model as a general model for developing countries

- Economic growth is characterized by urbanization. *Without urbanization, no economic growth.*

- Harris-Todaro model does not provide a clear path to long-run relationship between higher GDP/capita and lower shares of informal employment
In the Lewis Model the shift of unskilled workers from the informal ("subsistence") sector to the formal ("capitalist") sector is constrained by the number of jobs in the formal sector, which is in turn constrained by the scarcity of formal sector capital.
Lewis model provides a more useful foundation for evaluating formal-informal employment dynamics

- Lewis emphasized demand side constraints. That is, the cause of persisting informal employment is too few formal jobs.
New developments

Emerging forms of informal employment can be *complementary* with economic growth and globalization

- Informal employment in formal establishments (2003 ILO Definition)
- Informal employment in global commodity chains
Data on emerging forms of informal employment is scarce

- Anecdotal evidence suggests it is growing alongside other forms of irregular, precarious employment

- E.g., Posthuma and Nathan (2009) find informal employment throughout global commodity chains, in upper and lower tiers
To what extent have these developments weakened the linkage between economic growth and declining informal employment?

• Anecdotal evidence suggests a serious challenge to growth-oriented policies for reducing informal employment

*Economic growth is not enough*
II. The Effect of Labour Market Regulations on Informal Employment
Informality: Exit and Exclusion, World Bank (2007)

“A substantial body of literature sees the size of the informal sector to be determined substantially by regulatory distortions or corruption….. For the [LAC] region and several countries, a credible case can be built that labor legislation had a substantial impact on the size of the formal sector”

Description: Seven country studies use micro datasets to estimate the effects of “job security costs” on formal employment in Argentina, Barbados, Brazil, Chile, Jamaica, Peru and Trinidad and Tobago

Results:
Statistically significant results only for Argentina and Peru, with higher job security costs associated with lower formal employment

But what are the implications of job security costs for informal employment?...
...consider the case of Peru


- Job security costs fell while formal employment increased in Peru in the 1990s.

- However, informal employment increased even more rapidly, with the result that falling job security costs occurred alongside a rising share of informal employment.

Results for Peru are typical for the region...

**Description:** Cross-country panel data analysis of OECD and LAC countries, 1990-1999

**Model of:** Share of self-employment

**Key explanatory variable:** Job security index

**Results:**

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<th>OLS</th>
<th>Fixed effects</th>
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<tr>
<td>OECD plus LAC</td>
<td>1.37 (5%)</td>
<td>-8.43 (1%)</td>
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<tr>
<td>LAC</td>
<td>1.09 (10%)</td>
<td>-8.34 (1%)</td>
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Description: Cross-industry panel data analysis, 1983-2002

Models of: share of formal employment, formal job creation and destruction

Key explanatory variables: % of unionized workers, labour costs

Results:

- Greater unionization is associated with higher shares of formal employment
- Estimated positive and negative effects on formal job creation and destruction cancel each other over time
The authors conclude that the increase in informal employment in Brazil in the 1990s resulted from “increases in union power” and “rising labor costs.”
Given what is at stake for workers in developing countries, advocates of weakening of labour regulations as a policy to reduce informal employment ought to hold themselves to a high technical standard

*This standard has not been met*
Concluding remarks

The main cause of persisting informal employment is too few formal jobs

Contrary to:

- Predictions of the Harris-Todaro model
- Supply-side approaches
- Approaches emphasizing rigid labour markets
- The notion of “voluntary” informal employment
- “Exit” and “exclusion” more generally (WB 2007)
Concluding remarks cont’d…

- Emerging forms of informal employment appear to have weakened the linkage between economic growth and declining informal employment.

- The empirical evidence suggests that labour market regulations are not generally a cause of persisting informal employment.

- The debate on labour regulations should not be about regulation versus deregulation, but about the optimal design and implementation of labour regulations.