9 Trade and informality: Transition to formality and decent work

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Summary

- Informality is a significant characteristic of the global economy, particularly in developing and emerging economies. It is more prevalent in primary industries and lower tiers of certain manufacturing global value chains (GVCs), such as textiles, but also in services such as retail.

- The impact of trade on informal employment is heterogeneous across countries and depends on various economic factors, including the sector involved, as well as non-economic factors such as social aspects, and the institutional and regulatory context.

- Trade openness has the potential to either decrease or increase informal employment. It can decrease it by promoting economic diversification and encouraging a shift from low-productivity to higher-productivity activities; it can increase it by pushing economic units or workers out of the formal labour market due to higher competition.

- Participation in GVCs also has the potential to affect the informal economy. Both economic and social changes can occur as a result of upgrading or downgrading, with upgrading leading to improvements in workers' pay and working conditions or excluding informal workers and units from formal supply chains. Regional value chains can act as stepping-stones to GVCs, leading to improved diversification and productivity, and a decrease in informal employment.

- Strategies to support the formalization process through trade include trade diversification, participation in global and regional value chains, digital transformation (in particular e-formalization, e-commerce) and skills and enterprise development.

Background and introduction

This chapter offers an overview of trade and informality in the modern economy. The discussion starts by presenting an initial definition of informality during its nascent phases, as a collection of small-scale, unrecognized or unregulated operations, and then presents the concept in accordance with the current ILO perspective. Indeed, a significant proportion of employment in low-income and several middle-income countries is found within the informal sector. For example, the ILO estimates that the rate of informal employment in sub-Saharan Africa was 89.2 per cent in 2016.

Governments and the social partners have increasingly been prioritizing the transition from the informal to the formal economy in their policies, but with considerable variation in their approaches and even in the terminology used. The ILO's Transition from the Informal to the Formal Economy Recommendation, 2015 (No. 204) also recognizes the vast heterogeneity of the informal economy, and highlights the fact that there are various reasons why workers end up in informal employment.

The competitiveness and productivity of international trade, which is associated with frontier technologies, may seem to have little connection with the informal economy. However, some primary products, such as minerals and crops, are typically exported with little processing and involve a large number of informal workers. Furthermore, manufacturing activities in the lower tiers of global value chains, particularly in the textile sector, are also often performed at home by informal workers in arduous working conditions. The enhancement of international trade, accompanied with the right policy mix of industrial and employment policies, has the potential to create learning opportunities and facilitate structural transformation that promotes the transition of segments of informal employment to formality.

Research question and methodology

The chapter explores the relationship between international trade and informality, and the circumstances under which trade, or increased trade, could enhance the transition towards formality. It presents a comprehensive review of the literature on international trade and informality, from a theoretical and empirical perspective, followed by an empirical analysis of macroeconomic data to examine the distinct patterns across countries. The chapter also provides an in-depth examination of the factors that contribute to the promotion of formalization in the context of trade.

Concerning country-level data analysis, correlations between informal employment and several macro indicators, such as the Human Development Index (HDI), total employment and productivity, are analysed statistically. In addition, sectoral correlations in agriculture and manufacturing are examined to determine whether there are significant differences in these relationships based on the income levels of the countries under consideration.

Findings and policy considerations

The findings emphasize the complex relationship between trade and informality. Theoretical and empirical evidence demonstrate that international trade affects both formal and informal markets through multiple channels, with considerable variations across sectors, geographical regions, and the individual characteristics of entities such as workers and firms.

Notably, the chapter also shows divergent correlations based on country income levels, indicating a positive connection between informality and exports for low-, lower-middle- and upper-middle-income countries; high-income economies, by contrast, exhibit a negative correlation (see the figure below). This finding is particularly noteworthy since it demonstrates how income levels can affect the strength of the association between trade and informality.

The importance of transitioning to formal employment is also emphasized, particularly in light of achieving the Sustainable Development Goals (SDGs), especially SDG 8.3, which calls for the promotion of formalization and creation of decent jobs. A variety of policies are discussed that have proved effective in decreasing informal employment, including through international trade.

Economic diversification is a critical factor for formalization, primarily as it facilitates the movement of workers from low- to high-productivity jobs. In developing countries, this typically involves transitioning the labour force away from the agricultural sector, supporting micro, small and medium-sized enterprises, and promoting regional trade integration as a stepping-stone to GVCs. One such programme discussed is the Better Work programme, which was launched by the ILO and the International Finance Corporation in 2007 to improve working conditions in the garment sector for both formal and informal workers in GVCs.

It is noted that, instead of pursuing immediate global expansion, regional integration can serve as a viable strategy to mitigate the challenges faced by small and less developed economies. This is significant because neighbouring countries frequently have comparable demand conditions, which are easier for local producers to meet than if they attempt to sell to industrialized nations. Such a strategy could eventually lead to the formation of regional value chains, which can link more effectively with GVCs.

Digitalization can also be an important tool in transforming the tradable and non-tradable sectors. Improved e-formalization services could also enhance the transition to formality. However, regulatory oversight is crucial to avoid a situation where e-commerce increases informality in the short term.

Ultimately, the chapter emphasizes that formalization requires active government involvement, and that a pro-poor, inclusive approach can be achieved through carefully managed institutional policies.

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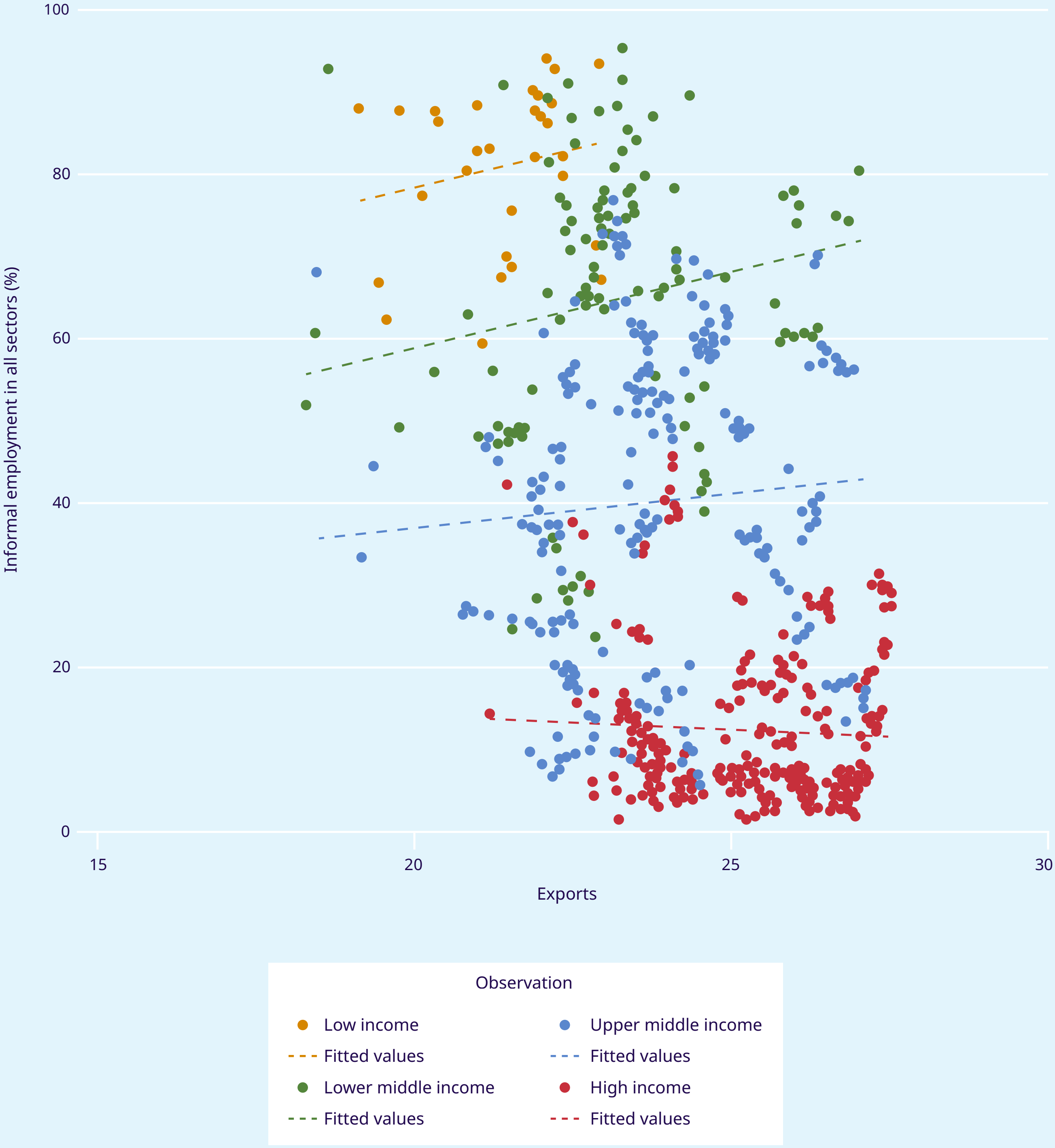
▶ **Overall informality versus total exports, by country income group, selected countries, 2009–19**



Note: The y-axis shows the share of informal employment in total employment in all sectors as a percentage; the x-axis shows the log of total merchandise exports. Country-year observations: 723. Each marker is one country-year observation.

Sources: ILOSTAT database for informality rate in all sectors; World Bank's World Development Indicators for data on exports.

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