

# Trade and informality:

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## Transition to formality and decent work

Christoph Ernst and Vicky Leung\*

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## ► Introduction

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Since the 1970s, informality has garnered increased attention, as numerous studies found that “poor people managed to make a living with small-scale activities which were not illegal, but were often not being recognized, recorded, protected and/or regulated” (ILO 1972, cited in ILO 2020, 144). The definition of informality has changed over time. The term “informal sector” used in the early 1970s was replaced by the concept of “informal economy” in 2002.<sup>1</sup> Since then, there has been a continuous and intense debate over the concept and definition of informality. Different interpretations have emerged ranging from informality as pent-up potential to informality as a parasitic organizational structure that hampers economic growth. Scholars have also explored the reasons behind informality’s existence as well as the appropriate measures and policies to tackle it (La Porta and Shleifer 2014) or to promote a development process leading to formal job creation.

One might initially presume that international trade has little to do with the informal economy, given that it is a highly competitive and productive area associated with frontier technologies. Despite the seemingly tenuous link between trade and informality, it is important to acknowledge that trade influences the degree of informality and vice versa (Sinha 2009). Developing countries often export primary products, such as minerals and crops, with minimal processing and a significant involvement of informal workers. Manufacturing activities in the lower tiers of GVCs, such as in the textile sector, are also often performed at home by informal workers in arduous working conditions (Textile Value Chain 2022).

Simultaneously, the engagement in international trade and foreign direct investment has the potential to create learning opportunities by facilitating knowledge transfer and knowledge diffusion,

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1 This variation is partly reflective of the discussions held during the 90th Session of the International Labour Conference in June 2002. During this conference, the ILO made the decision to discontinue use of the term “informal sector”. This change was prompted by the realization that the term “sector” denotes a distinct specific industry group or economic activity. Instead the ILO adopted the much broader term “informal economy”, which encompasses a continuum of informal employment found in both the formal and informal sectors, as well as informal enterprises. The International Labour Conference adopted a resolution in 2002 where “informal economy” was taken to refer to “all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements” (La Hovary 2014). Recommendation No. 204, adopted at the 104th Session of the International Labour Conference in June 2015, uses the same definition and further specifies that the informal economy does not cover illicit activities.

in particular at the local level (Ola-David, Alege and Oyelaran-Oyeyinka 2015). Trade may also play a role in facilitating structural transformation,<sup>2</sup> as in the case of export-led growth observed in South-East Asia. Structural transformation is a major driver of changes in a country's labour market structure by promoting the transition of segments of informal employment to formality.

Traditional trade theories (Gopinath, Helpman and Rogoff 2022; Stiglitz 2002) do not allow an adequate analysis of trade and informality, because they typically assume a context of full employment – without making any distinction between formal and informal employment (ILO 2021) – and a costless labour market adjustment. Consequently, these theories generally neglect the painful transition process for enterprises and workers or the overall development impact, which could be quite negative. Even though trade generates aggregate benefits, the gains are often shared unevenly across sectors, subsectors, industries and firms, but also geographically across regions and between factors of production such as capital and labour (Bacchetta et al. 2021). These distributional effects cause rising inequality through the labour market channel. “New” trade theory and “new-new” trade theory focus more on the intersectoral and intrasectoral effects of trade on informality (ILO 2021).

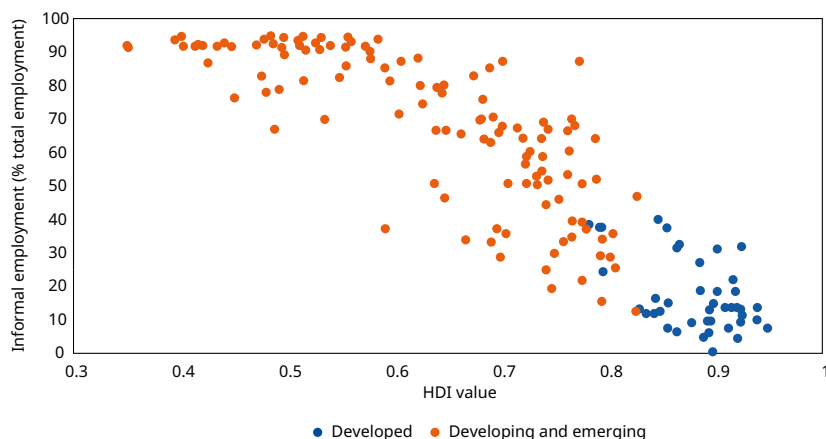
Indeed, international trade, if accompanied by an appropriate policy and regulatory framework, can promote structural transformation, for example through export-led growth shifting the economy from low- to high-productivity sectors (Ghose, Majid and Ernst 2008). Accordingly, trade has the potential to contribute significantly to increasing the share of formal workers in the economy. This transition to formalization would be an important step in improving the gains from trade, fostering decent work and achieving the SDGs.

An international comparison of national data by the ILO (ILO 2018a) demonstrates a negative correlation between informality and the Human Development Index (figure 9.1). In a similar vein, an additional analysis conducted by the ILO (Leung 2021) demonstrates a negative correlation between the level of GDP per capita and the share of informal employment in total employment. Hence, more development and growth goes hand in hand with a decline of informal employment (ILO 2018a).

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2 With regard to trade and structural transformation, which in general implies the move from low-productivity agriculture to the higher-productivity manufacturing sector, UNCTAD (2016) distinguishes between three phenomena: (a) “catch-up industrialization” like that of East Asian countries; (b) “stalled industrialization” with pockets of excellence, but limited technical spillovers, as observed in India or Mexico; and (c) “premature deindustrialization”, as experienced in South America or Northern Africa.

► **Figure 9.1** Share of informal employment (percentage of total employment) versus Human Development Index, by level of economic development, selected countries, latest available year



**Note:** All estimates have a common set of operational criteria, which defines informal employment and employment in the informal sector as a worker's main job. See box 2 in ILO (2018a) for a detailed explanation of how informal employment is measured. The Human Development Index is a measure developed by the United Nations Development Programme (UNDP) that tries to include the overall level of accomplishment in key aspects of human development.

**Source:** ILO (2018a, figure 17).

In this regard, 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. Indeed, the choice of terminology is very much related to the perception of the problem and thus also influences the policy choice (Chacaltana and Leung 2020). The 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.

Policy options to promote the transition to formality thus depend very much on factors such as the structure of labour markets, the pattern of informality, and institutional and normative settings (ILO 2020). One of the key findings in the main conclusions of a recent ILO study (Chacaltana and Leung 2020) is that labour market composition determines significantly the overall informality rate of an economy. Without modifying labour market structures, it would be highly challenging to lower informality rates in a sustained manner. Informality is more associated with the levels and patterns of development than with choices made by the individual.

Against this background, this chapter will shed further light on the relationship between trade and informal employment, in particular on the circumstances in which trade or increased trade could enhance the transition towards formality. The analysis is based on a review of the literature in section 9.1, together with statistical analysis of recent global trends in trade and labour market data in section 9.2; and policy analysis on transition to formalization through trade policy in section 9.3. Section 9.4 draws the chapter's conclusions.

## ► 9.1 Trade and informality: What the theory and empirical evidence tell us

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### 9.1.1 Theoretical approaches

In a typical developing country, national demand for products is rather limited and the elasticity of demand for consumption products is low, hampering economic growth (Weisskoff 1969). As a result, there is limited scope for increased revenue from domestic sales, and little incentive to increase productivity, to widen the variety of goods and services, or to improve their quality. Trade presents an opportunity to expand the destination market for nationally produced goods and services, but also to obtain imports of much-needed final or intermediate goods, which may also stimulate national production. Alternatively, increased imports could lead to a decline in the consumption and production of national goods that are less competitive than imported ones, which could have a negative impact on growth and (mostly industrial) development.

Trade indirectly influences informal employment via its impact on productivity and growth. Overall, trade openness is positively correlated with per capita income and economic growth, both of which are loosely tied to the rise of formality. Recent research by Bacchetta et al. (2021) has demonstrated that an increase in trade openness of 1 per cent of GDP is associated with per capita GDP being 2 to 6 percentage points higher; while an ILO study points to a negative correlation, albeit a weak one, between economic growth (generated by trade) and informality (Chacaltana, Bonnet and Garcia 2022). Economic structure and the patterns of growth are aspects which shape informality. In that regard, economic diversification and complexification,

along with the level of technology used, have a strong influence on the transition towards a more formal economy, as discussed further below. The sectoral distribution of GDP and the pattern of GDP growth also matter (Leung 2021). Structural change is considered the key driver of growth and of reduction of the share of informal employment in the economy. The reallocation of jobs across sectors is an important aspect of structural change and productivity upgrading. Informal activities and enterprises are generally less productive than formal ones. The rise in productivity as a result of increased trade may be associated with the structural transformation process – that is, a diversification of the economy moving towards higher-productivity sectors, or towards subsectors within a sector, which leads to a higher share of formal employment and to strong and sustained growth and development (Islam and Lapeyre 2020).

Thus, another (more direct) channel whereby international trade influences informal employment is through the evolution of trade flows at the sectoral level impacting directly on informal units and workers. International free trade in a context of perfect competition may generate net positive welfare and productivity effects worldwide, but increased trade may also have both positive and negative effects on specific firms and countries in the short to long run.<sup>3</sup> Trade opening influences trade flows, creating new export opportunities, but it also means having to cope with higher import penetration and competition, and having to address how these changes in exports and imports directly affect informal units and workers.

At the individual level, the effects of trade liberalization will also depend on its sectoral pattern, on where poor and informal workers live (rural versus urban areas), their individual characteristics (skill level, gender), the type of trade policy change (that is, whether it leads to increased import competition or export opportunities) and where individuals work (type of industry, firm size, formal/informal sector) (Bacchetta et al. 2021).

Trade liberalization often leads to stiffer competition for domestic firms. This could result in higher informality because companies shed formal jobs to lower production costs (Fugazza and Fiess 2010; Ulyssea, Bobba and Gadenne 2023). According to Melitz (2003), a rise in competition through

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3 However, at present there is far from perfect free trade worldwide owing to various kinds of unilateral trade restrictions and bilateral, subregional and regional trade agreements and preferences, all of which have a distorting effect.

trade opening causes the more productive companies to enter the export market and the least productive ones to exit, leading to a rise in productivity.<sup>4</sup>

Additionally, unilateral trade liberalization, combined with financial deregulation and the retreat of extensive state interventions (UNCTAD 2016), may lead to strong import competition and limited growth in certain sectors, the disappearance of entire sectors and subsectors, and the bankruptcy of some formal enterprises.<sup>5</sup> Barriers to trade, such as high administrative and quality requirements and challenges related to logistics, transport, language and culture, are even more cumbersome for smaller, informal enterprises and the self-employed in the informal economy than for larger firms in the formal economy. A period of transition towards a new and higher economic equilibrium could be costly and painful for some types of workers and firms and endanger social equality and justice.

Thus, the relationship between trade liberalization and informality is ambiguous from a theoretical point of view.

## 9.1.2 Empirical evidence

### 9.1.2.1 Trade and productivity

There is a significant gap in labour productivity between the traditional and modern parts of the economy in developing societies. A key driver of inclusive development is labour flows from low- to high-productivity activities. The empirical results presented by Fugazza and Fiess (2010) suggest that productivity in the informal sector increases after trade opening, but that liberalization also encourages the dissemination of knowledge, innovation and technological upgrading through “learning by exporting” and skills accumulation, which are key channels for raising growth. As pointed out by Bacchetta et al. (2021) and Cerra et al. (2021), solid evidence can be found in the literature showing the positive impact of trade liberalization

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4 This was demonstrated by Cisneros-Acevedo (2022) for Peru, where trade liberalization led to the exit of informal companies with low productivity, causing a decrease in informality on the “extensive margin” where workers were hired by unregistered firms. At the same time, formal companies in Peru hired informal workers to cut costs because of stronger competition, leading to a rise in the “intensive margin” of informality. In general, greater labour demand among (old and new) exporting firms may put upward pressure on formal or informal wages depending on which force dominates, possibly leading to a rise in informality.

5 Indeed, the conventional wisdom that import liberalization may lead to job displacement in the short run, but not in the long run, has not been confirmed by empirical results (Görg 2011).

on productivity in the manufacturing sector, which can be explained by the reallocation to more productive companies or by improvements within firms (see also De Loecker and Goldberg (2014); Melitz and Redding (2014); Ahn et al. (2016); Dix-Carneiro et al. (2021)). This would imply that only the most productive informal enterprises remain active and even expand production after trade opening, which confirms the findings of Bacchetta et al. (2021).

A study by McMillan and Rodrik (2011) showed more nuanced results. For countries such as India, China and some other East Asian economies, increased trade led to increased productivity because of structural transformation and growth. Many other countries, mainly in Africa and Latin America, exhibited an opposite trend towards less productive activities and thus a larger informal economy. This can be ascribed to the fact that in those countries structural transformation detracted from overall growth. A large proportion of their exports is accounted for by the extraction of natural resources, which may be highly productive but is not very labour-absorbing.

Indeed, productivity differentials are an important feature in countries with high levels of informality (IMF 2017, 2021; La Porta and Shleifer 2008; Chacaltana and Leung 2020). Recent data have made it possible to better assess such differentials. Estimates by the International Monetary Fund in 2019 show that informal GDP in sub-Saharan Africa was close to 34 per cent of total GDP between 2010 and 2017 (IMF 2021). Meanwhile, the ILO estimates that the rate of informal employment in sub-Saharan Africa was about 89.2 per cent in 2016. This would mean that informal workers, who account for almost 90 per cent of the workforce in sub-Saharan Africa, generate 34 per cent of GDP, while formal workers, who make up the remaining 10 per cent, produce 66 per cent of GDP in that region. The productivity differential between the formal and informal economy is therefore enormous with a value of 17 times (ILO 2020). The same study finds that informal units are in general small and extremely unproductive compared with small, medium-sized and large firms in terms of value added, sales and output per worker. The findings of World Bank Enterprise Surveys in sub-Saharan Africa suggest that the productivity level of informal firms is significantly lower than that of their formal counterparts, as one would expect (IMF 2017). The productivity of informal firms is on average about 25 per cent of that of small formal firms and just 19 per cent of that of medium-sized formal firms in terms of real output per employee. A lower level of physical capital and workers' skills lies behind this productivity differential.

Various country studies have investigated the relationship between trade, productivity and employment:

- ▶ De Loecker and Goldberg (2014) and Melitz and Redding (2014) demonstrate that trade openness raises productivity across countries and particularly benefits sectors in which lower tariffs reduce input costs.
- ▶ Ferreira and Rossi (2003) observed improved productivity in specific industries in Brazil as a result of the trade reforms of the late 1980s.
- ▶ Dix Carneiro et al. (2021) found that in Brazil gains in productivity are understated when the informal economy is omitted. By the same token, while the repression of informality improves productivity, at the same time it has a negative effect on welfare and employment. However, the productivity effect does not depend only on trade changes but also on existing institutions; that is, on labour and product markets (Dix Carneiro et al. 2021).
- ▶ Bacchetta et al. (2021) observed trade shifts in general production towards sectors that have the highest comparative advantage but often not the highest employment potential.
- ▶ Ahn et al. (2016), in a global study, showed that the indirect impact in downstream industries with a high share of informal activities mostly accounts for the rise in productivity, and not the direct effects in targeted upstream sectors.
- ▶ Experience from Latin America suggests that the key factor to productivity growth is not trade but the internal structure of the economy, the availability of skills and the degree of specialization. No virtuous circle could be found between structural change due to trade opening, the rise of product and productivity and the absorption of underemployment (Cimoli 2005).

Countries' experiences show, therefore, a general trend that increased trade does lead to increased productivity and lower informality, but can also negatively affect formal employment. The total effect does not seem very significant and other effects may play an even bigger role (for example, institutions). Therefore, productivity gains in the formal sector do not automatically translate into an overall productivity gain across the economy, including the informal economy, because of overall demand constraints. Whether the gains in the export sector generate activities in the rest of the economy depends on the trajectory and robustness of economic growth.

### 9.1.2.2 Trade opening and its impact on informal employment

Trade opening, leading to changes in import and export flows, has had different impacts on countries, depending on their level of development and on different segments of the labour market, such as formal and informal workers.

Table 9.1 provides an overview of global studies primarily analysing the impact of trade opening on the labour market, with a particular focus on informality (including wage considerations). The studies do not provide a definitive assessment on whether trade opening has led to a reduction or increase in informality, including from a gender perspective. The impacts of trade opening are contingent upon various contextual factors, such as the sector involved, trade partners, the extent of tariff reductions, non-tariff barriers and others. Additionally, it is crucial to consider the timing and sequence of trade opening, as well as the broader international circumstances during the specific period of implementation.

► **Table 9.1 Trade opening and informal employment: country cases**

| Author                                                                | Country | Topic                                   | Main finding                                                                                                                                                       |
|-----------------------------------------------------------------------|---------|-----------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Aleman-Castilla (2006)                                                | Mexico  | Impact of NAFTA                         | Lower import tariffs related to lower informality in tradables                                                                                                     |
| Dix-Carneiro et al. (2021)                                            | Mexico  | Impact of NAFTA                         | Informality decreased less in manufacturing with a higher level of import penetration                                                                              |
| Ben Yahmed and Bombarda (2020)                                        | Mexico  | Tariff cuts and employment, gender      | Tariff cuts increased the probability of working formally for both sexes. In the services sector, women were less likely to work formally                          |
| Bacchetta, Ernst and Bustamente (2009)                                | Mexico  | Impact of trade liberalization on wages | Trade opening widened the gap between formal and informal wages, and increased the skill premium                                                                   |
| Paz (2022)                                                            | Brazil  | Import penetration from China and RoW   | Higher imports led to higher likelihood of manufacturing jobs becoming informal                                                                                    |
| Goldberg and Pavcnik (2003); Bosch, Goñi-Pacchioni and Maloney (2012) | Brazil  | Trade and informality                   | No significant relationship between informality and trade. Labour market institutions and reforms have a stronger impact on informal employment than trade opening |

| Author                                 | Country      | Topic                                        | Main finding                                                                                                                                                                          |
|----------------------------------------|--------------|----------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Bacchetta, Ernst and Bustamente (2009) | Brazil       | Impact of trade liberalization on wages      | Trade liberalization narrowed the gap between formal and informal wages                                                                                                               |
| Cisneros-Acevedo (2022)                | Peru         | Increased import competition and informality | Extensive informal employment declined and intensive informal employment increased, which drove the overall effect leading to higher informality                                      |
| Cruces, Porto and Viollaz (2018)       | Argentina    | Trade reforms and informality                | Reduction in industry tariffs increased labour informality; higher effect in industries with small enterprises                                                                        |
| Sinha (2010)                           | India        | Trade reforms and informality                | Fall in import tariffs led to a decline in demand for regular labour, and an increase in supply of informal employment                                                                |
| Bacchetta, Ernst and Bustamente (2009) | India        | Impact of trade liberalization on wages      | Trade liberalization raised informal wages in manufacturing through the reallocation of capital from the formal to the informal sector                                                |
| Artuc et al. (2019)                    | India        | Increase in exports                          | Higher exports reduced the level of informality in India, especially for male, urban workers and low-skilled workers, and increased their wages, but also inequalities                |
| Davies and Thurlow (2009)              | South Africa | Trade opening and employment                 | Trade opening lowered employment and affected informal producers and workers negatively; positive impact on informal traders                                                          |
| McCaig and McMillan (2020)             | Botswana     | Trade liberalization and jobs                | Trade liberalization caused a rise in the prevalence of working in an informal firm or being self-employed; mixed effects on unemployment; decline in hours worked and monthly income |

Additionally, other studies have found that trade liberalization is sometimes closely associated with deindustrialization, particularly in developing nations. Summarizing various studies on sub-Saharan Africa, Shafaeddin (2005) concluded that trade liberalization has often caused some degree of deindustrialization in that region, mainly due to the fact that many developing countries there are latecomers to industrialization. Their industries are at an earlier stage of infancy than those of other countries and face stiff competition from international firms (Altenburg and Melia 2014). This situation may even result in stalled industrialization, as in the case of Mexico and, to some extent, Indonesia and Thailand in the late 1990s, or even in deindustrialization and increased informality, as shown in several

studies on Latin American countries in the 1980s and 1990s (Bogliaccini 2013; UNCTAD 2016).

On the plus side, trade may lead to new export opportunities for informal workers and units in export sectors with high growth potential in their respective value chains. The challenge is to get from export opportunities to real exports. As formal companies may not be able to fully meet the new export potential, informal companies can seize these opportunities if they manage to overcome certain limitations preventing them from operating as exporters, such as lack of information on the quality requirements of destination countries, logistical bottlenecks and lack of access to export insurance services.

### 9.1.2.3 Trade and informality in global value chains

GVCs are a prominent feature of international trade. There are different views of the impact of GVCs on informality. According to Rodrik (2018), GVCs are in general biased towards skills and other capabilities, thereby limiting the comparative advantage of developing countries in labour-intensive manufacturing activities and reducing their gains from trade. Second, developing countries face difficulties in using their labour cost advantage to offset their technological disadvantage, since GVCs reduce their ability to substitute unskilled labour for other production inputs.

Various studies of deregulation have demonstrated that outsourcing and competitive pressures within GVCs have led, through the shifting of costs and risks down the chain, to increasing levels of informality and poverty in the countries involved (see, for example, Jütting, Parlevliet and Xenogiani (2008); Chen (2007)). In his review of the literature, Görg (2011) similarly noted that offshoring may lead to a reshuffling of employment and labour displacement that affects mostly unskilled workers and workers in the non-tradable sector, in which the bulk of informal labour is to be found. Informal workers often contribute to the extraction or cultivation of primary products and do not participate in processing; they may work informally in formal enterprises or they may work at home and deliver their inputs to formal enterprises, as in the textile sector (Abramo 2022). According to a recent study by Herr and Teipen (2022), social downgrading as a result of participation in GVCs was observed in Bangladesh, India and Viet Nam, but there are also the positive examples of Brazil and South Africa, where accompanying active public policies, together with measures taken by the social partners (in particular trade unions), enabled social upgrading.<sup>6</sup>

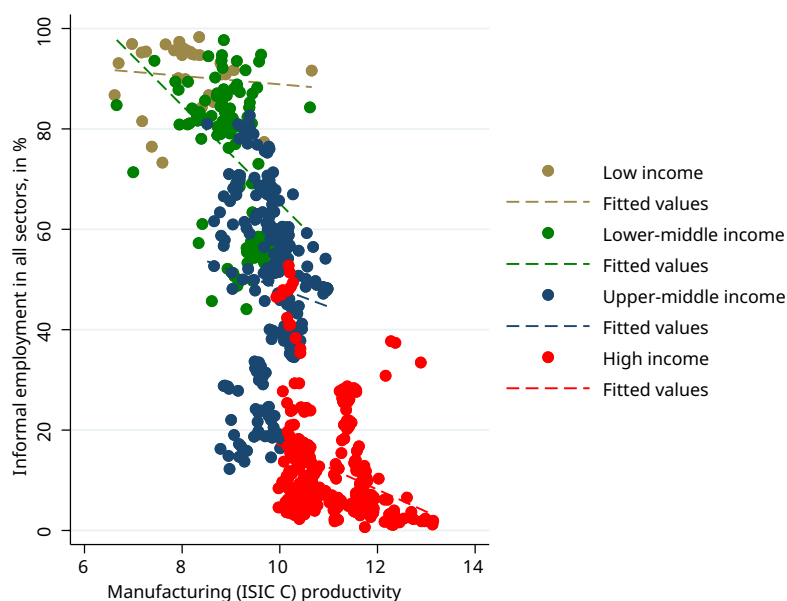
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6 For more positive examples, such as Mexico and Viet Nam, also with a gender focus, see World Bank (2020, 76–91).

## 9.2 Global trends

An analysis of data from 2009 to 2019, encompassing a large sample of economies, confirms a noteworthy and positive correlation between productivity and exports.<sup>7</sup> Given that exporting is typically associated with higher productivity, it is pertinent to examine the relationship between productivity and informal employment across countries at different levels of development.

► **Figure 9.2** Informality in all sectors versus manufacturing productivity, by country income group, selected countries, 2009–19



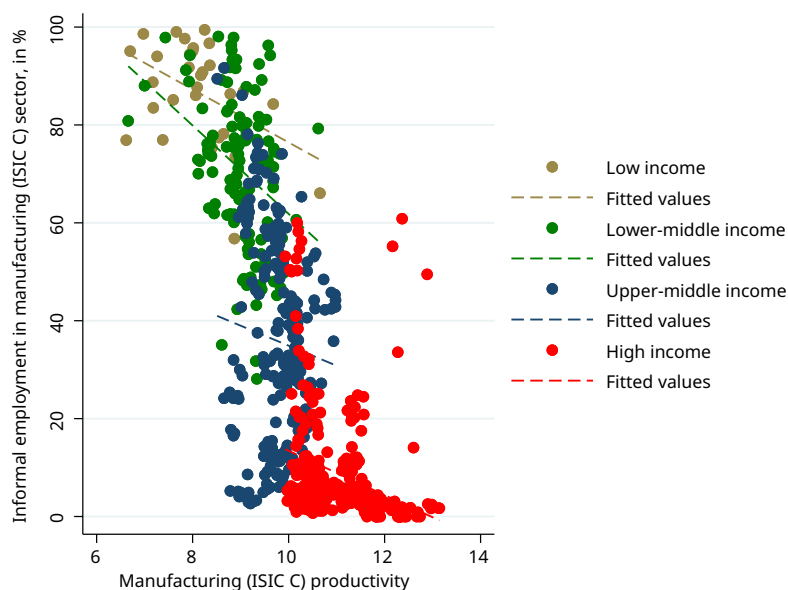
**Note:** The y-axis shows the share of informal employment in total employment as a percentage; the x-axis shows manufacturing productivity, measured as value added by the manufacturing sector (in current US dollars), divided by the total number of employees (both formal and informal) in the manufacturing sector. Country-year observations: 699. Each marker is one country-year observation for the years between 2009 and 2019.

**Source:** ILOSTAT database for informality in all sectors and total number of employees in manufacturing; [World Bank World Development Indicators](#) for value added by the manufacturing sector.

<sup>7</sup> Specifically, a correlation coefficient of +0.48, with  $p < 0.001$ , for a pair-wise correlation of the natural logarithms of productivity and exports for 2009–19 ( $N = 337$ , excluding high-income countries).

As can be seen in figure 9.2, informality in all sectors is negatively correlated with manufacturing productivity (value added per employee), with the correlation coefficient (that is, the gradient of the slope) being quite close to that of manufacturing informality versus manufacturing productivity (figure 9.3). The relatively flat slope for low-income countries should be noted here: it can mostly be explained by the high prevalence of agriculture, where the rate of informal employment is over 60 per cent, compared with less than 5 per cent in manufacturing. This becomes clearer if one focuses on the two main sectors, agriculture and manufacturing (see figures 9.3 and 9.4).

► **Figure 9.3** Informality versus productivity in the manufacturing sector, by country income group, selected countries, 2009–19



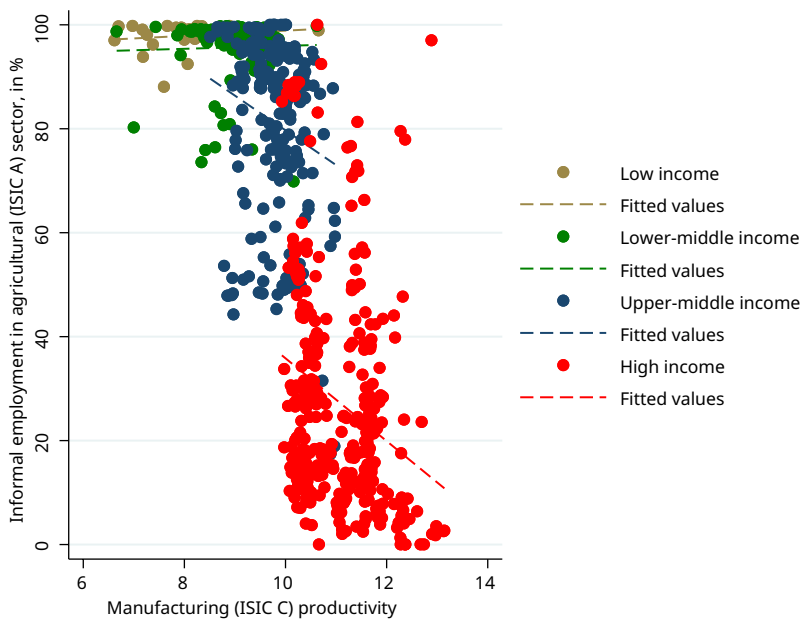
**Note:** The y-axis shows the share of informal employment in total employment in the manufacturing sector (ISIC Rev. 4, section C) as a percentage; the x-axis shows manufacturing productivity, measured as the value added by the manufacturing sector (in current US dollars), divided by the total number of informal workers in the manufacturing sector. Country-year observations: 696. Each marker is one country-year observation for the years between 2009 and 2019.

**Source:** ILOSTAT database for informality rate and informal employment in the manufacturing sector; [World Bank World Development Indicators](#) for value added by the manufacturing sector.

Analysis of the manufacturing sector (figure 9.3) reveals a negative correlation between productivity and informal employment. From 2009 to

2019, the countries with higher manufacturing productivity tend to have lower informality. The slope is similar for high-, upper-middle- and low-income countries. The correlation for lower-middle-income countries is more negative than for the other income groups, which we assume may be explained by their lower level of manufacturing development.

► **Figure 9.4** Agricultural informality versus manufacturing productivity, by country income group, selected countries, 2009–19



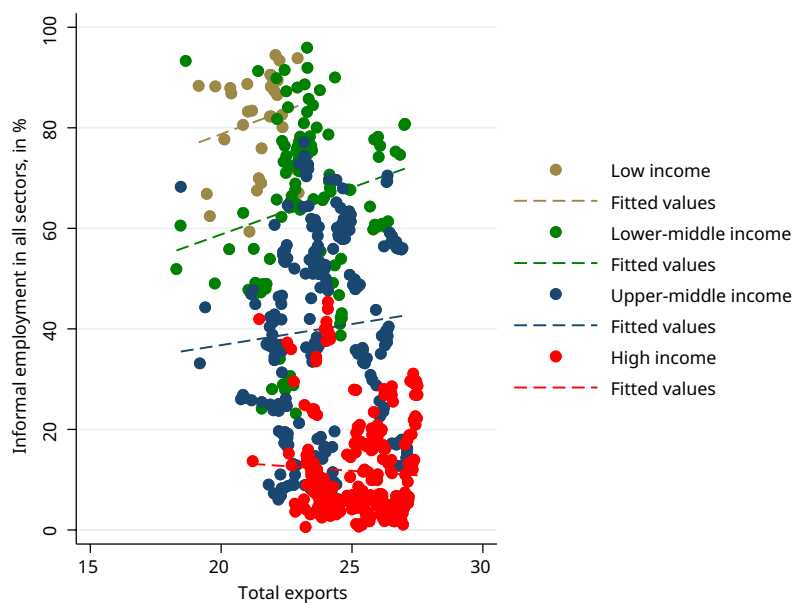
**Note:** The y-axis shows the share of informal employment in total employment in the agricultural sector (ISIC Rev. 4, section A) as a percentage; the x-axis shows manufacturing productivity, measured as the value added by the manufacturing sector (in current US dollars), divided by the total number of informal workers in the manufacturing sector. Country-year observations: 696. Each marker is one country-year observation for the years between 2009 and 2019.

**Source:** ILOSTAT database for informality rate in the agricultural sector and informal employment in the manufacturing sector; [World Bank World Development Indicators](#) for value added by the manufacturing sector.

Regarding agriculture (figure 9.4), it may be observed that spillover correlation (between manufacturing productivity and agricultural informal employment) is limited to high-income and upper-middle-income countries, whereas the slope for lower-middle-income and low-income countries is essentially flat.

Figure 9.5 shows the correlation between informal employment in all sectors as a percentage of total employment and total exports of goods in current US dollars over the period 2009 to 2019. One would expect higher exports to reduce overall informality. However, this is not the case for low-income, lower-middle-income and, to a lesser extent, upper-middle-income countries, which exhibit the opposite trend. This could be mainly due to two factors. The first is data limitations (fewer observations), although that is insufficient to explain the same phenomenon for lower-middle-income countries, for which there is a higher number of observations. The second factor is that the majority of informal workers (above 50 per cent) are concentrated in agriculture. Overall informal employment in all sectors (the y-axis) is primarily driven by the agricultural sector in lower-middle-income and low-income countries. Intuitively, as exports increase, the agricultural sector experiences less spillover improvement in terms of formalization.

► **Figure 9.5 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 merchandise exports. Country-year observations: 723. Each marker is one country-year observation.

**Source:** ILOSTAT database for informality rate in all sectors; [World Bank World Development Indicators](#) for data on exports.

As expected, a scatter plot of informality in manufacturing versus manufacturing exports (see figure A1 in the Appendix) reveals a negative correlation. Upper-middle-income countries have a slightly steeper slope than the rest, indicating a stronger correlation between the two variables. This may reflect the process of transition to formality, where export-oriented production itself provides the incentive for labour migration from the agricultural to the manufacturing sector (in which workers are more likely to be in formal employment). However, the formality effect also depends on political and economic institutions, which often reflect a country's development and income levels (see, for example, Acemoglu, Johnson and Robinson (2005)).

A comparable scatter plot for agriculture (see figure A2 in the Appendix) reveals a negative correlation solely for high-income countries, whereas all other countries do not exhibit an increase in formal employment with increased agricultural exports. This observation implies that the backward and forward linkages between agriculture and manufacturing in these countries are relatively limited, indicating a potential for enhancement through the promotion of international trade.

In summary, recent research demonstrates that informality can respond to trade opening either positively or negatively in terms of employment and income, depending on national circumstances and the characteristics of a given industry (Fugazza and Fiess 2010). There is no distinct relationship between trade and informal employment, as other factors – such as the institutional and regulatory setting of each country; the timing, sequencing and extent of trade liberalization; and the time taken to adjust to the new context – significantly impede the relationship.

## ► 9.3 Policies promoting transition to formality through trade

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### 9.3.1 Diversification and informality

Economic diversification through trade is key to economic development as a country moves to a more diverse production and trade structure, leading to reduced economic volatility, less dependency and sustained growth.

Diversification also means moving labour from low-productivity, informal jobs, traditionally in agriculture, to higher-productivity, formal ones, often though not exclusively in urban areas. Indeed, a recent ILO study drawing on country data from 1991 to 2019 found that the degree of formalization depends on a country's economic structure and pattern of growth (Chacaltana, Bonnet and Garcia 2022). Public policies should therefore promote diversification, sectoral complexification and technological sophistication to increase the number and quality of jobs, thereby fostering the transition to formality (Brenton, Gillson and Sauvé 2019). A good example is provided by countries in East Asia that achieved such a growth transition in the 1990s by adopting an export-led strategy, which began with the exporting of labour-intensive manufactured goods.

According to Usman and Landry (2021), economic diversification also leads to fiscal diversification, which means expanding the sources of government revenue and raising public expenditure targets. Such diversification may be essential to facilitate broader economic transformation through the expansion of activity in specific sectors, subsectors, industries or geographical areas.

Some studies have suggested that diversification in most developing regions, especially in Africa, should focus on agriculture and mining, as these two sectors account for a large share of regional GDP. Countries in such regions should, it is argued, follow an industrialization strategy based on backward and forward linkages from and to these sectors – in particular, agricultural demand-led industrialization through agro-processing and input supplies and spillovers (Altenburg and Melia 2014). As a result, increased agricultural productivity would have a positive impact on non-farm employment in the rural area. This is a strategy with considerable potential to benefit many poor people in rural areas.

During a mission to Africa in 2017, the then Managing Director of the International Monetary Fund, Christine Lagarde, mentioned some countries that had successfully shifted their resources into higher-productivity sectors (including sectors outside the natural resources industry):

- Rwanda, which had experienced a rapid shift of employment and output from basic agricultural production to higher-value activities, in particular services.
- Botswana, which had built on its comparative advantage in diamonds by moving up the value chain into diamond cutting, polishing, trading and retailing.

- Mauritius, which had switched from single-crop farming in the 1960s to more sophisticated agriculture, tourism, manufacturing and financial services (Lagarde 2017).

Greater diversification does not automatically mean further inclusion of informal workers in the labour market, but a recent study by Moyo (2016) has shown precisely that in the case of two of the above-mentioned countries, Botswana and Mauritius. Key policies used to that end were the provision of intensive support to micro, small and medium-sized enterprises and local contractors (through, for instance, the Local Enterprise Authority in Botswana), including support to achieve higher productivity and thus competitiveness (through, for example, skills policies that also targeted low-skilled and unskilled workers); the use of local resources (including innovation and technology); the support of domestic demand for those enterprises' products; and regional trade integration schemes. In both countries, the state played a crucial role in promoting a long-term development strategy oriented towards exports, and in combining trade and industrial policies with enterprise development and labour market policies, together with associated policies in the fields of energy, transport and communications, with a special focus on labour market inclusion.

Rwanda increased its exports by about 20 per cent annually from 2000 to 2016 thanks to a new policy framework for the diversification of its export portfolio (including services, apparel and leather products, mechanical appliances and beverages, and agro-processing products), while at the same time improving the quality of traditional commodity exports (such as coffee). Regional markets have played a key role in supporting this diversification (Brenton, Gillson and Sauvé 2019).

Chile is also an example of a country that has followed a two-track diversification strategy in the mining and agricultural sectors: (a) diversification "within" the industry, for example, improving the quality of copper extraction and exporting processed goods, thus increasing the value added (this is complemented by the development of domestic ancillary and logistics services); and (b) diversification "across" industries (for example, the development of the salmon industry and increased exporting of high-value-added agricultural products, in particular wine, fruit and vegetables) (WTO and OECD 2019). Moreover, Chile has a structural fiscal surplus rule and sovereign funds so that the revenue from mineral extraction can be saved and invested in areas that are critical for the country's growth. This has freed up resources to promote the development of advanced skills, but also to facilitate the creation of high-growth start-ups in promising sectors, such as salmon farming (Brenton, Gillson and Sauvé 2019).

### 9.3.2 Global and regional value chains

Recent country experience has shown that GVCs have the potential to create new and better jobs for informal workers, but that they can also lead to casualization and higher employment insecurity. Within GVCs, the lead firm does not, in general, transfer key competencies to suppliers as that would be a way of creating future competitors and would be at odds with its profit-maximizing goal. Integration into global markets therefore requires active public policies to trigger economic catch-up through economic and social upgrading. Otherwise, developing countries will find themselves trapped in low-tech and labour-intensive production with a high level of informality according to their comparative advantages (Herr and Teipen 2022).

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 particularly relevant as neighbouring countries often have similar demand conditions, which are comparatively less challenging for local producers to fulfil than exporting to industrialized countries.

An interesting example is the Better Work programme launched by the ILO and the International Finance Corporation in 2007 with a view to improving the labour situation of both informal and formal workers in GVCs in the textile sector, especially that of women, who are often employed informally in formal enterprises (ILO n.d.). The programme has succeeded in continuously improving compliance with core labour standards and national legislation (for example, on compensation, contracts, OSH and working time), leading to better working conditions at factories and greater productivity and profitability.

As always, much depends on the policy and regulatory framework set up by each country, as well as on the international context. Nadvi (2004) and the World Bank (2020) stress the importance of attracting global buyers and thus foreign direct investment, but also of ensuring that these are committed to promoting the upgrading of skills and improving the returns to local firms so as to facilitate their integration into more advanced GVCs. The aim should be to remove the barriers preventing informal workers from participating in GVCs so that they can access job opportunities with higher added value in the world market (AfDB, OECD and UNDP 2017).

In some Latin American countries (Brazil, Ecuador, Mexico and Peru), efforts have been made to develop value chains that link the informal parts with the formal ones – for example, by making the formalization of employment a prerequisite for supplier firms to participate in public procurement (Abramo 2022).

Through consumer pressure and related institutional pressure, various frameworks and norms have been designed with the final aim of formalization, for example, on regular working hours, the respect of minimum wages, OSH or working conditions (Meagher 2019). Under its new regulatory approach to GVCs, the EU has been paying particular attention to due diligence legislation,<sup>8</sup> including in its more recent trade agreements. The focus is on preventing human rights abuses (Rudloff 2022), which in this context also applies to informal employment within GVCs. Unfortunately, the implementation of such due diligence laws has not been so effective: they have ignored some important aspects (such as freedom of association) or exhibited monitoring and enforcement deficits (Madhav and von Broembsen 2021). Additionally, various multinationals have demonstrated a commitment to eliminating the use of precarious and informal types of employment in their GVCs, but sometimes with the perverse effect of excluding informal workers from the value chain instead of trying to improve their working conditions.

Regional value chains (RVCs) are different from GVCs, as countries export finished, but also intermediary products primarily within the region or sub-region. This allows them to climb up the ladder in value chains by using the region for enhancing their competitiveness when they start producing and exporting goods and services of higher value. The regional market can also serve as a stepping stone for subsequent expansion to other countries and the creation of RVCs, which can link more effectively with GVCs, thereby also improving these countries' bargaining power vis-à-vis multinationals (UNCTAD 2018). RVCs offer interesting new opportunities for the development of trade and employment creation, not least for lower and unskilled workers, in supplying a less competitive regional market. However, there are only a few specific examples, mainly from Asia, that can be considered a clear success so far.

UNCTAD (2018) presents a useful illustration of a regional opportunity by looking at the leather sector in Africa. The region has a comparative advantage in this sector owing to the abundance of raw material, low-cost processing capabilities and export opportunities for leather products. Nevertheless, Africa's potential is still far from being fully tapped because of low regional integration and hence limited intraregional trade in leather goods (about 14 per cent of the region's global exports), severely limiting the scale of production and lowering the region's cost competitiveness.

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8 The European Commission, for example, has adopted a directive on corporate sustainability due diligence to promote sustainable and responsible corporate behaviour throughout GVCs, not least with regard to the use of informal and precarious employment (EC 2022).

It is hoped that the promotion of RVCs will make African countries more cost competitive and increase their bargaining power in negotiations with multinationals, as well as improving their capability to climb up the GVC for leather and additional products (see, for example, MacLeod in Volume 2).

### 9.3.3 Digital transformation of trade and formalization

The penetration of digital technologies in trade and formalization offers another angle from which to look at the relationship between the two and its implications for policymaking. Digital trade,<sup>9</sup> especially e-commerce, involves cross-border sales and therefore contributes to international trade; its most relevant contribution is turning non-tradable services into tradable ones in the form of digital products.

While the extent to which e-commerce contributes to international trade depends very much on the nature of the product to be delivered physically or digitally, some analysts argue that e-commerce is still expected to create new employment opportunities directly and indirectly, including high-skilled jobs. It may also destroy some jobs by changing the traditional way of doing business (ECLAC 2002). Others have argued, though, that e-commerce increases informality in the short term because operational and financial risks are often allocated to weaker participants in the value chain who are employed by subcontractors and mainly operate informally, creating unfair transnational competition among workers with different levels of social protection (Spatari 2019). That is why policymakers need to understand better what type of e-commerce activities and related policies can ensure that the positive impact of digital trade on employment and labour productivity extends to informal workers and facilitates their transition to formality.

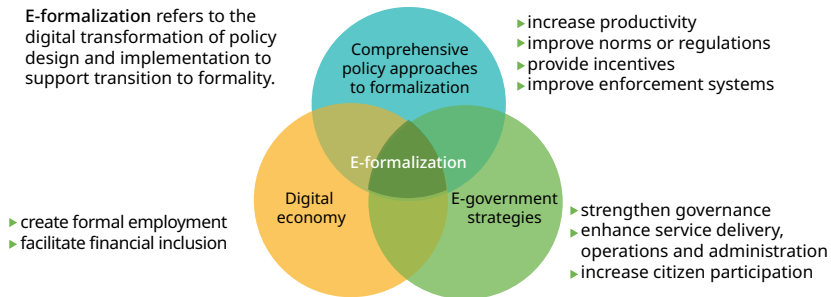
Before and during the COVID-19 crisis, developing and developed countries around the world – for example, in Colombia (Olivera 2022), the Republic of Korea (Kring and Elder 2022) and Estonia (Divald 2021), and at the regional level in Europe (Williams 2021) – were using digital technologies to facilitate formalization, thus increasingly including workers in the informal economy. The concept of “e-formalization” can be described as the aggregate effect of three interlinked approaches and actions: (a) coordination across a range of government policy areas that are relevant for transitions to formality; (b) support for the digital economy, of which digital trade, especially

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9 According to UNCTAD (2022), “digital trade” refers to both digitally ordered trade in goods and services (cross-border e-commerce) and digitally delivered trade (services delivered internationally through the internet or other networks) (see also UNCTAD (2021)).

e-commerce, forms an important part; and (c) development of e-government services (figure 9.6) (Kring and Leung 2021).

**Figure 9.6 Policy spheres linked to e-formalization**



**Source:** Kring and Leung (2021).

Although informality is a persistent problem in rural areas in developing countries, the case of China shows that e-commerce offers employment opportunities for semi-skilled workers and other vulnerable groups in rural areas who face barriers to entry into the formal labour market. The findings of a survey of “Taobao villages” in the country (that is, villages participating in e-commerce via the Taobao online platform) suggest that digital trading has created such opportunities through three main channels: (a) fostering entrepreneurship (such as self-employed e-shop owners); (b) creating jobs directly related to e-commerce (such as e-shop workers and jobs that directly serve e-shops, including website designers, models to advertise products and photographers); and (c) creating jobs indirectly related to e-commerce with upstream or downstream linkages (such as logistics services and providers of materials and intermediate inputs for e-shops). The Taobao village model has revitalized rural areas and reduced poverty levels among the local population (World Bank and Alibaba Group 2019).

The experience of different countries confirms that the success of e-formalization very much depends on the extent to which supporting policies, including the delivery of public services through digital technologies, focus on improving conditions and expanding opportunities for informal workers. The beneficial effects of digital transformation on trade and formalization can only be realized fully if the process is managed properly and geared towards pro-poor, inclusive outcomes. It is important to maximize the potential of e-commerce and develop coordinated strategies with the right

mix of economic and institutional policies that are tailored to each national context (Leung 2021).

## ► 9.4 Conclusion

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As this chapter has made clear, increased trade and exports will not automatically lead to a universal transition to formality and a higher share of formal employment. Trade may increase the demand for national products, improve a country's economic diversity and, thereby, increase production and productivity. It may open up new export opportunities and help to integrate national producers effectively into RVCs or even GVCs. On the other hand, export expansion may also imply greater vulnerability to external factors (Shafaeddin 2005) and thus higher economic volatility. Increased import competition can even lead to a deindustrialization process; countries may find themselves stuck in a "low-level" specialization or at the bottom of the value chain with poor working conditions and potentially a rise in informality.

Successful trade depends on a number of factors: the regulatory and institutional framework and the macroeconomic context; the setting of policies (not just labour market policies, but also industrial, trade and associated policies) at the national and international level;<sup>10</sup> the timing and sequencing of trade reforms and associated reforms;<sup>11</sup> the (previous) level of development; and various intersectoral and intrasectoral factors. These policies must be first of all coherent and integrated, but also inclusive, proactive and designed to tackle the specific challenges faced by informal units and workers when it comes to participating in international trade and in global and regional value chains.

The aim should be to enhance domestic absorptive capacity, which is key to innovation, productivity growth and output (Ola-David, Alege and Oyelaran-Oyeyinka 2015). This is very much related to the promotion of

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<sup>10</sup> This implies, among other things, political stability, the enforcement of contracts, property rights, standards for certification, and respect for labour rights. Developing countries also benefit from privileged access to industrialized countries through the international trade system and its mechanisms (including RTAs, WTO rules, tariff escalation and rules of origin), but this rarely translates into higher exports, so those mechanisms should be reviewed and strengthened.

<sup>11</sup> As emphasized by Altenburg and Melia (2014), such reforms should be implemented at a slow pace, giving even informal workers and units time to learn and adapt their productive activities to the new circumstances, and they need to be accompanied by a series of focused support measures (policies, regulations, institutions).

informal apprenticeship and the recognition of prior (informal) learning (Hofmann et al. 2022; ILO 2018b). Such efforts tie in with capacity-building for small informal enterprises, including capital mobility and formalization of credit. Linkages between firms should be reinforced across subsectors of the private sector and modern investments should be used for technology diffusion. There are various ethical trade initiatives that aim – through networking and alliances between companies and/or non-governmental organizations in developed countries and local producers in developing countries – at facilitating informal and small producers' access to international markets, improving trading conditions, raising income, and enhancing consumer awareness with the help of networks between local firms in developing countries and international firms and non-governmental organizations at the international level (ILO 2007 and Chant 2008).

Other labour market policies (such as public employment services, regulations on OSH and working conditions, and special targeted interventions for young people and women) could complement these support measures. Respect for the labour rights of informal workers has to be guaranteed and their participation in social dialogue promoted. Trade, accompanied with a right and integrated policy mix could therefore provide a positive contribution to inclusive development.

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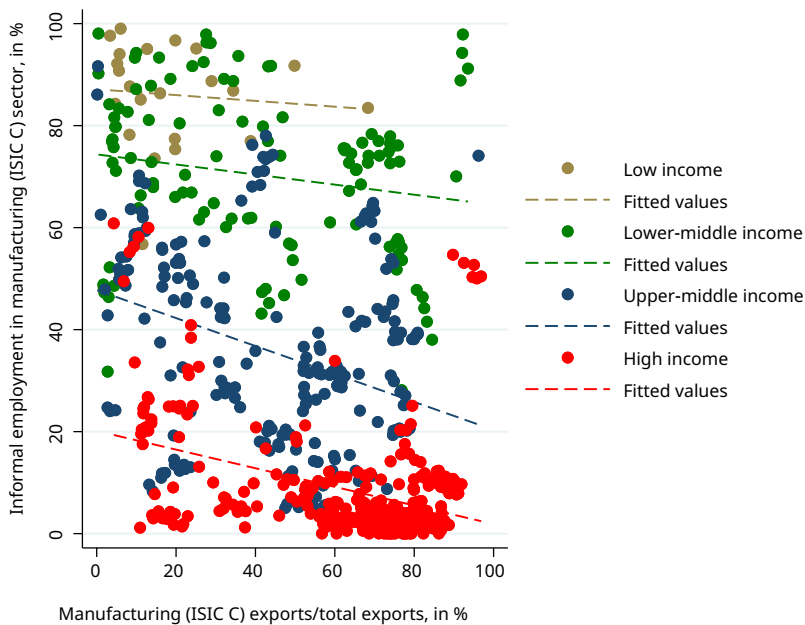
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## ► Appendix

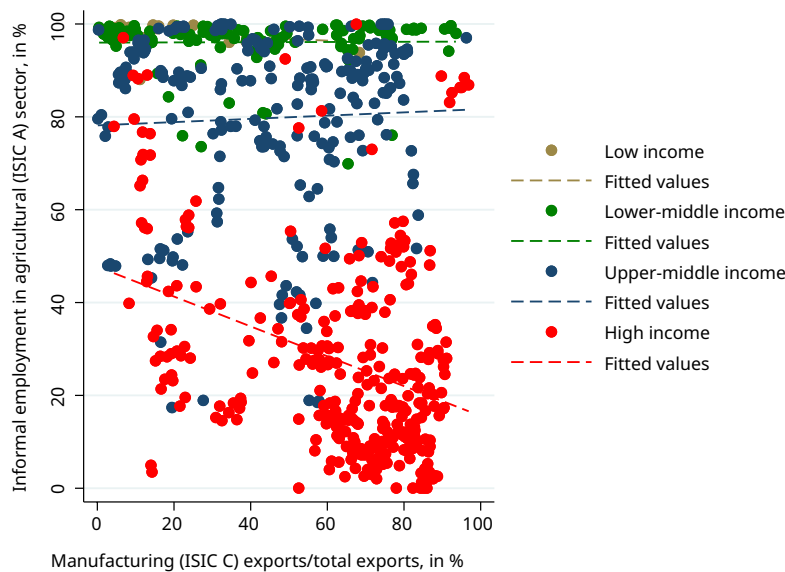
► **Figure A1** Manufacturing informality over share of exports in manufacturing (scatter plot), 2009–19



**Note:** y-axis is informal employment in the agricultural sector (ISIC Rev. 4 section level A), in percentage, 100 = 100%; x-axis is manufacturing exports (as % of merchandise exports) of country in year  $t$  (this is essentially a proxy for manufacturing focus of export), 100 = 100%. Country-year observations: 694. Each marker is one country-year observation, 2009–19.

**Source:** ILOSTAT, [World Bank World Development Indicators](#).

► **Figure A2** Agricultural informality over share of exports in manufacturing (scatter plot)



**Note:** y-axis is informal employment in the agricultural sector (ISIC Rev. 4 section level A), in percentage, 100 = 100%; x-axis is manufacturing exports (as % of merchandise exports) of country in year t (this is essentially a proxy for manufacturing focus of export), 100 = 100%. Country-year observations: 691. Each marker is one country-year observation, 2009–19.

**Source:** ILOSTAT, [World Bank World Development Indicators](#).



