Growth Strategies and Quality Employment Generation

International Labour Office
Geneva

Worker transporting a sack of potatoes on his back, Peru.

3.1 PATTERNS OF ECONOMIC GROWTH AND THE INFORMAL ECONOMY: FINDING THE POLICY MIX TO CURB INFORMALITY

While economic growth is an essential element in reducing informality, evidence suggests that there isn't an automatic relationship between the two. Indeed, there can be cases where informality may persist despite strong economic growth. This brief endeavors to show that the policy mix supporting economic growth is a key determinant of the way economic growth impacts on informality. The brief makes the case for the importance of policies for inclusive and job-rich growth, and, in the emerging approaches section, looks at the sorts of integrated policies which can achieve this.

KEY CHALLENGES

- Economic growth alone cannot reduce informality
  - GDP per capita and informality
- Recent trends in informality
  - Late 20th century trends in informality
  - Early 21st century trends in informality
  - The period from the financial crisis

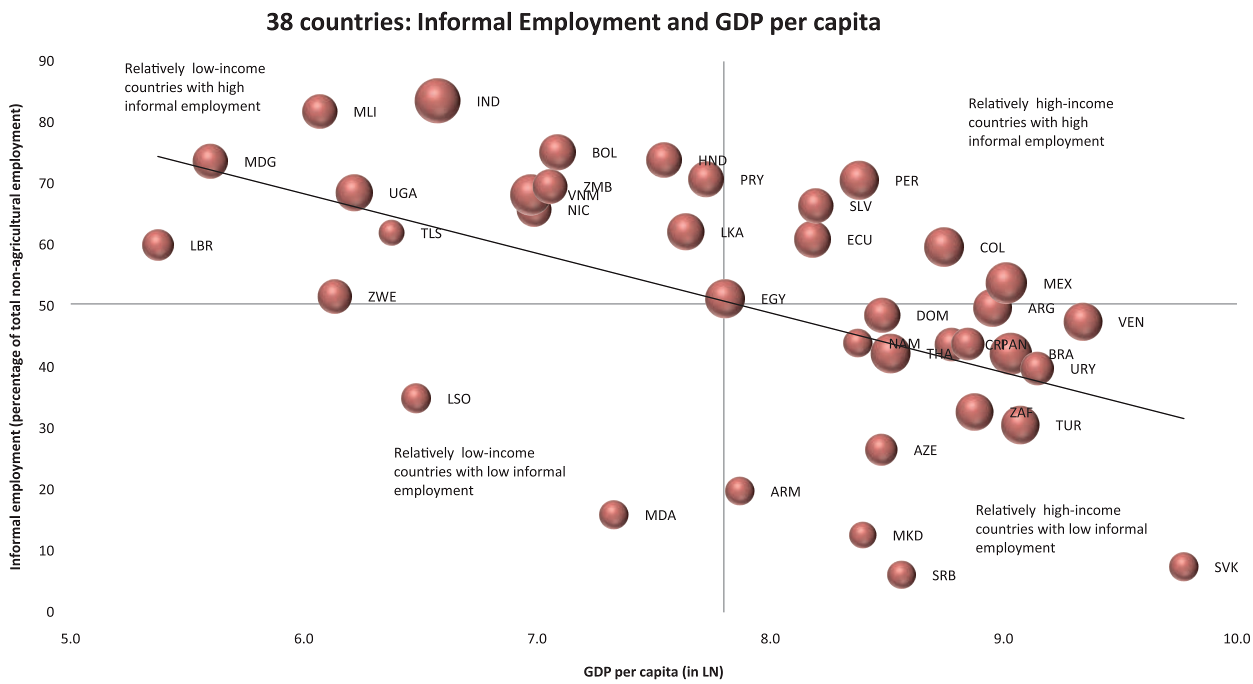
What is economic growth?

Economic growth is defined as the expansion of the productive potential of the economy. Annual economic growth is measured by annual percentage increase in real gross domestic product (GDP). Depending on the policy mix supporting it, economic growth may be capital intensive resulting in limited job creation, or conversely, it may have a high employment content. The pattern of economic growth is likely to have an impact on the extent of poverty reduction and the pace of improvements in living standards.

Early theoretical analyses of the informal economy (or informal sector/ traditional sector as it was previously termed) held the view that informality was a temporary phenomenon that would dissipate once economies grew and absorbed the surplus labour within it. Contrary to expectations, informality has not disappeared, but instead persists and often appears in new guises in both developed and developing countries. Even more perplexing is that informality can sometimes be impervious to strong and sustained economic growth. What has become clearer is that there is a complex relationship between economic growth and informality. This is illustrated for example in analysis of the graph below which shows informal employment and GDP per capita.

● Informality can grow even in spite of economic growth

Figure 1: GDP per capita and informality



Source for data: ILO, Department of Statistics and IMF, World Economic Outlook

Source: ILO 2011. Statistical Update on Employment in the Informal Economy.

This graph shows for each country the percentage of informal employment in total non-agricultural employment and the value of income per capita (expressed in natural logarithm). Country names have been abbreviated due to space constraints. The axis passes through the unweighted sample means. A linear trend line is depicted, and the size of the bubbles reflects the size of total informal employment (in logarithms). Only countries with data on persons in informal employment have been included. GDP data correspond to the same year as latest year available on employment in the informal economy.

One way of capturing the impact of sustained economic growth on the incidence of informality in the long run is to focus on the relationship between GDP per capita and the prevailing economic structure. The use of increases in per capita GDP as a proxy for structural transformation makes sense if there is reliable empirical association between levels of per capita GDP and an index of economic structure. It is plausible to assume that the share of informal activities in an economy can stand as a proxy for the preponderance of low productivity activities. In that case, increases in per capita GDP should allow us to track the evolution of the informal economy, that is, higher GDP per capita is associated with lower levels of informality. This is what the graph above aims to do. To fix ideas, consider two countries that fall on the 'line of best fit' – Madagascar and Brazil. Madagascar has a per capita income (US 2010 prices) of 421 while Brazil has a per capita income of 10,721 (USD 2010 prices). As one makes the transition from Madagascar to Brazil, the share of informality declines from 75 per cent to 45 per cent. How long will it take Madagascar to reach Brazilian per capita GDP?

If GPD per capita grows at a rate of 7 per cent per annum, the per capita income doubles in just over 10 years. So, using this simple rule-of-thumb, it will take more than 40 years for Madagascar to reach the Brazilian threshold and attain the associated share of informality of 45 per cent. In any case, few countries in the world – 13 according to the Growth Commission [1] – have managed to grow at 7 per cent for two to three decades. This means that the probability that the typical developing country will grow at rapid rates is quite low. Madagascar is no exception. Hence relying on a 'growth only' strategy is not a particularly effective way of reducing informality within a reasonable time frame.

An additional reason why the focus needs to go beyond growth alone, is that the graph plotting per capita GDP-informality relationship shows that there are considerable deviations from the 'line of best fit'. In other words, countries at similar levels of per capita GDP exhibit significant variations in the incidence of informality. This means that there are country-specific factors pertaining to a complex mix of institutions and policies that can enable a country to reduce its degree of informality for any given level of per capita income.

What this graph shows overall is the first hint that while economic growth is vital to reduce informality, the policy mix that surrounds it is also of great importance. In the same way that it has now become well established that economic growth on its own is insufficient to reduce poverty, it has also become clearer that economic growth on its own cannot curb informality. What is needed is an examination of the types of economic growth strategies which can either increase or decrease informality. In order to explore the relationship between economic growth and the effects on the informal economy this brief will look at two questions:

1) What have been the recent trends in informality and the growth strategies linked to it?
2) What sorts of policies need to be implemented if economic growth is to result in a reduction of informality?

1 See Resources section to access: Commission on Growth and Development, World Bank

■ Recent Trends in informality

It is helpful to look at recent broad trends in informality to further tease out the notion of the critical importance of the policies surrounding and complementing growth in relation to impacts on informality. This part of the brief will look at three broad periods: the last decades of the 20th century, which saw increases in informality, the early 21st century which was a period of moderate decline of informality, and the period from the global financial crisis from 2008 to the present.

- **The later decades of the 20th century.** During the late 20th century there was a general increase in the informal economy in many countries around the world. Heintz and Pollin, for example, show that within a data set of 23 countries, 19 showed increases in informality. Similarly, ILO data from 2002 shows that self-employment increased in all developing regions, and world-wide increased from about one quarter to one third of non-agricultural employment during the period 1980 - 2000 [2]. Furthermore, Charmes (2000), using data from national sources, has shown that the relative weight of the informal sector increased significantly in all regions in relation to non-agricultural employment between 1980 and 1999[3].

It is important to examine the policy environment of the time to see the factors that underpinned this increase. During the later decades of the twentieth century many countries adopted economic models of development based on what became known as the 'Washington consensus'. This model emphasized tight monetary policy to keep low inflation, fiscal prudence, free markets, and a circumscribed role for the state. The policy environment supported free trade, financial liberalization, market deregulation, privatization, making labour markets more flexible, outsourcing production and the growth of temporary and casualized work[4]. These policy prescriptions often resulted in economic growth which had a very low employment content. Moreover the types of jobs that were created were often of poor quality – lowly paid and poorly regulated – and often found in the informal economy. Analysis of this type of growth strategy has revealed that without an explicit focus on increasing the demand for labour, economic growth will not generate as many jobs as needed, nor will it have a major impact on reducing poverty and informality [5]. Since work is the primary source of income for the poor, lowly paid and insufficiently productive jobs mean that the poor will not be able to earn enough to enable themselves and their families to work their way out of poverty. Thus we can see that the period of increase in informality in many countries and regions around the world was at a time when free-market oriented economic models dominated policy making[6].

● Informality grew in many parts of the world during the late 20th century, which was also a period when neo-classical economic models were adopted

- **Early 21st century trends in informality.** While informality increased during the last decades of the 20th century, the early 21st century – a time of global economic prosperity - saw a moderate decline in informality. The evidence for this can be seen in the following data from the working poverty indicator, the vulnerable employment indicator and direct estimates.

2 These estimates were done prior to the development of direct methods of establishing data on the informal economy. In the absence of direct estimates, self-employment - a major component of employment in the informal economy, was a useful indication of the level of informality. For more details see brief on Statistical Measurement for more details.

3 See Charmes ,J. 2000. *Size, Trends and Productivity of Women's Work in the Informal Sector,* Paper presented at the Annual IAFFE Conference, Istanbul, 15-17 August.

4 See Resources section to access *Chen,M. Vanek,J. Heintz.J. 2006. Informality Gender and Poverty: A global picture. Economic and Political Weekly. May 27 2006. 2121-2139.*

5 Ibid.

6 See Resources section to access: Heintz and Pollin 2005

Working poverty as an indicator of informality

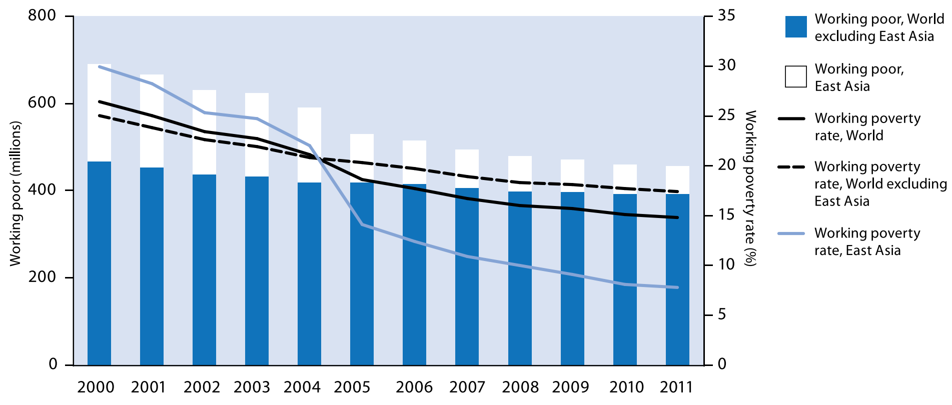
Working poverty is a useful indicator when focusing on informality, firstly because the main employment related problem in developing countries is less a problem of widespread unemployment (the poor are too poor not to work) but rather mass underemployment and working poverty; and secondly because there is a frequent overlap between being amongst the working poor and working informally. Although some activities in the informal economy offer reasonable livelihoods and incomes, most people engaged in the informal economy face insecure incomes and a wide range of decent work deficits. Many workers in informal employment, including own account workers, unpaid contributing workers, and those operating very small enterprises, often have lower earnings and face higher poverty risks than those working in formal employment. Thus there are strong linkages between informality and working poverty.

See also brief on Statistical challenges

Working poverty

Recent ILO data from 2012 (Figures 2 and 3 below) on working poverty reveals some progress over the last decade, but nonetheless rates and levels of working poverty remain unacceptably high. As the graphs below show, there has been a decline in extreme working poverty (persons living below the US$1.25 per day poverty line)[7]. Similarly there has been a reduction in the numbers of persons living below the US$2 per day poverty rate – mainly as a result of declines in poverty in East Asia and China[8].

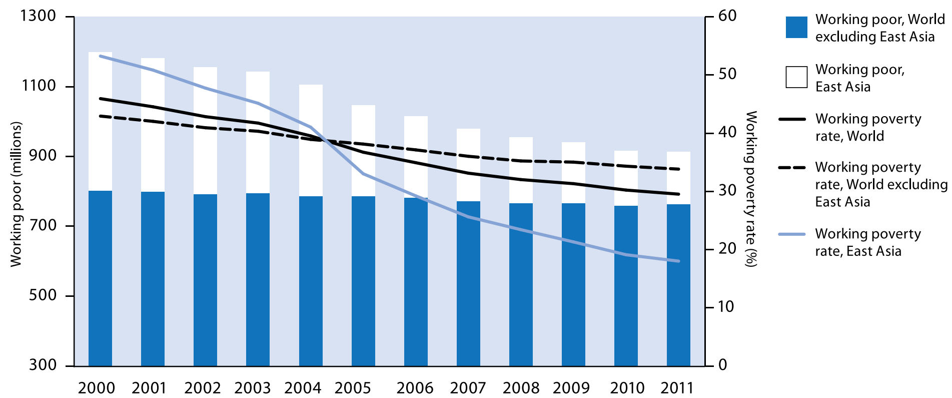
Figure 2: Global working poverty trends 2000-11 (US$1.25 a day)



Note: 2011 is a preliminary estimate.

Source: ILO, Global Employment Trends, 2012

Figure 3: Global working poverty trends 2000-11 (US$2 a day)



Note: 2011 is a preliminary estimate.

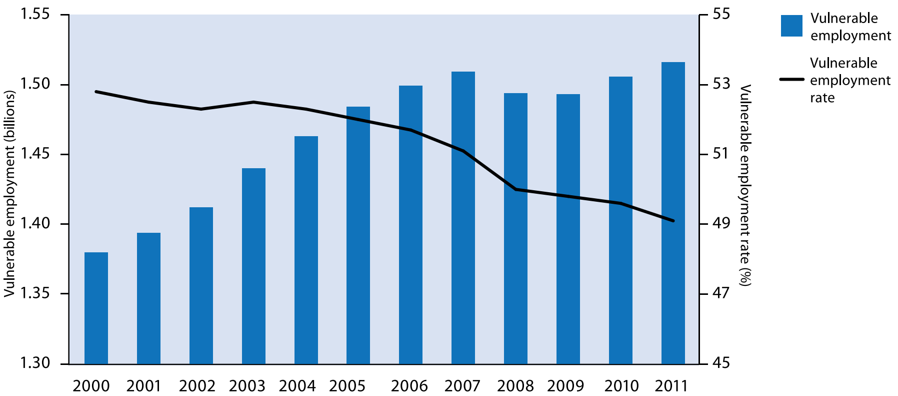
Source: ILO, Global Employment Trends, 2012

7 See Resources section to access: ILO 2012, Global employment trends 2012 page 41
8 See Resources section to access: ILO 2012 Global employment trends 2012 page 41

Vulnerable employment

Figure 4 shows a declining trend of global vulnerable employment (defined as the own-account workers and unpaid family workers) of 49.1 per cent, down from 52.8 per cent in 2000[9]. This moderate decline however, was not sufficient to prevent absolute numbers of workers in vulnerable employment from increasing by nearly 23 million since 2009, as a result of the expansion of the labour force in those countries heavily affected by vulnerable employment conditions.[10]

Figure 4 Global Vulnerable employment trends 2000-11



Note: 2011 is a preliminary estimate.

Source: ILO, Global Employment Trends, 2012

Direct estimates of informality

The ILO has time series data for 15 countries which shows total informal employment, employment in the informal sector and informal employment outside the informal sector as a share of non-agricultural employment for 2 or 3 points of time: in or around 2000, 2005 and 2010 (see Table 1 on page 7). This sample of 15 countries is not large enough to be representative. Nonetheless the available data suggests that, in the developing world, total informal employment is increasing in some countries such as Zambia and India, decreasing in middle and higher income countries (Latin America, with the exception of Mexico and Thailand); and that in transition countries employment in the informal sector is increasing[11].

Vulnerable employment as an indicator of informality

Another indicator when looking at informality is the vulnerable employment indicator which looks at the total of own-account workers and unpaid family workers. This indicator provides insights into trends in overall employment quality. A large share of vulnerable employment indicates widespread informal work arrangements, often lacking social protection, poor coverage by social dialogue and limited enjoyment of fundamental rights. There are limitations to it however, as discussed in ILO Global Employment Trends 2010: 1) wage and salary employment is not synonymous with decent work, as workers may carry a high economic risk despite the fact they are in wage employment; 2) the unemployed are not included in the indicator, though they are vulnerable; 3) a worker may be classified in one of the two vulnerable status groups but still not carry a high economic risk, especially in the developed world.

See also brief on Statistical measurement

● Direct estimates of informality show a moderate decline in the early 21st century

9 Ibid.
10 Ibid.
11 ILO and WIEGO (forthcoming), Women and Men in the Informal Economy: A Statistical Update 2012

Table 1: Informal non-agricultural employment and its components – Time series

Country	Year (Quarter)	Informal employment	Employment in the informal sector	Informal employment outside the informal sector
		as % of total non-agricultural employment		
Argentina	2003 (IV)	60.8	35.5	25.5
	2005 (IV)	57.0	33.4	23.7
	2009 (IV)	49.7	32.1	17.9
Ecuador	2005 (IV)	65.7	40.2	26.0
	2009 (IV)	60.9	37.3	24.0
Mexico	2005 (II)	53.2	34.9	19.1
	2009 (II)	53.7	34.1	20.2
Panama	2005 (Aug)	48.2	30.6	17.7
	2009 (Aug)	43.8	27.7	16.3
Peru	2005	76.3	52.7	24.0
	2009	69.9	49.0	21.7
Uruguay	2006	43.4	37.4	10.8
	2009	39.8	33.9	9.8
South Africa	2001	46.2	24.6	21.6
	2005	39.1	20.3	18.8
	2010 (IV)	32.7	17.8	14.9
Zambia	2005	59.4		
	2008	69.5		
Turkey (a)	2005		44.0	
	2009		46.2	
Moldova, Rep. of	2005	19.4	6.3	13.1
	2009	15.9	7.3	8.6
Russian Federation	2000		8.2	
	2005		13.0	
	2010		12.1	
Ukraine	2000		7.0	
	2005		7.8	
	2009		9.4	
India	1999-2000	80.4	67.7	13.5
	2004-2005	83.5	68.8	15.4
	2009-2010	83.6	67.5	16.8
Sri Lanka (b)	2006	62.2	51.0 (c)	11.6 (d)
	2009	61.8	49.8 (c)	12.0 (d)
Thailand	2006	42.6		
	2010	41.9		

(a) Employers and own-account workers only.
(b) Excluding Northern and Eastern Provinces.
(c) Including domestic employees and producers of goods exclusively for own final use by the household.
(d) Excluding domestic employees and producers of goods exclusively for own final use by the household.

Note: Due to the existence of some formal wage employment in the informal sector, for some countries total informal employment is slightly lower than the sum of informal sector employment and informal employment outside the informal sector.

Source: ILO and WIEGO (forthcoming). Women and Men in the Informal Economy: A Statistical Update 2012

Thus we can see from the various data sources that the recent pattern, at least until the onset of the global financial crisis in 2008, has been of a moderately declining trend in informality. What is important to note is that this downward trajectory in informality was in a period of global economic boom. During the period 2000-2007 global GDP was estimated to have grown by 4.2 per cent, compared with 3.1 per cent during the preceding eight years (1992–1999)[12]. Emerging and developing economies experienced particularly high rates of economic growth, averaging 6.5 per cent from 2000-2007 compared to 3.6 per cent during the period 1992–1999[13]. Despite strong economic growth in many parts of the world, the impact on reduced informality was surprisingly modest. While an assessment of the various growth strategies pursued during this period around the world is beyond the scope of this brief, this finding again suggests that economic growth alone is insufficient to reduce informality.

• **Trends in informality: from 2008 to the present.** With regard to the most recent period since the global financial crisis, the long term impacts on the size of the informal economy are yet to be determined. The epicenter of the crisis has been in high income countries, with the emerging economies and developing economies less impacted and in some cases making a faster recovery[14]. Evidence from country aggregates does show a universal deceleration in growth and it can be postulated that there has been at the least, a slow-down in the rate of poverty reduction in many developing countries[15]. This has more than likely also contributed to a slow-down in the decline in informality, though the precise impact on the size of the informal economy in different countries is as yet unclear[16]. Since there appears to be a strong link between the policy environment surrounding growth and its effect on informality, it follows that a number of factors will come into play in determining the impact on the informal economy in individual countries, including: the way the crisis has been transmitted to specific countries, the sector affected and importantly, the policy responses to mitigate the crisis.

● The impact of the global financial crisis on the informality levels in different countries will depend on the way the crisis has been transmitted, the sectors affected and the policy responses to address the crisis

These trends and data on informality provide insights into the complex relationship between growth and informality. The informal economy grew during the later decades of the 20th century, a time when neo-classical economic models were adopted in many countries. The more recent trend (the first years of the 21st century) has been of a downward trajectory in informality at a time of considerable economic prosperity around the world. Nonetheless this decline was fairly modest. And the trends relating to the global financial crisis and beyond are yet to be determined. What these periods do show clearly is that while economic growth is essential, it is clearly not sufficient on its own to decrease informality. This is further borne out by a study by Heintz and Pollin of 20 countries which shows that growth will *reduce the rate at which informalization is increasing in developing countries, though it*

12 Data taken from IMF World Economic Outlook 2010, page 208. http://www.imf.org/external/pubs/ft/weo/2010/02/pdf/text.pdf

13 Ibid.

14 Majid, N (2011) The Global Recession of 2008-09 and Developing Countries in From the Great Recession to Labour Market Recovery: Issues Evidence, and Policy Options, I.Islam, S. Verick (eds) (ILO Geneva 2011)

15 Ibid.

16 Leaving aside whether and how much the informal economy has grown as a result of the crisis, there is clear evidence that it has hit particular groups very hard. For example WIEGO/ Inclusive Cities research from Asia, sub-Saharan Africa and Latin America shows that in four informal sectors, the income and employment trends during the crisis – decreasing demand and wages aggravated by rising competition are the strongest in the poorest paying and lowest barriers-to-entry informal sectors and sub sectors where women are concentrated. The crisis is compounding women's paid and unpaid work burdens. As a result the socio-economic vulnerability of poor working women has deteriorated as a result of the crisis. For more details see Resources section to access: Horn,Z. 2010. *The effects of the global economic crisis on women in the informal economy: research findings from WIEGO and Inclusive cities partners*. In Gender and Development, Volume 18, Issue 2, 2010

cannot on its own, create an environment in which informalization actually declines. The study also found that increasing rates of informalization are consistent with positive average rates of economic growth. And finally, the weight of evidence does suggest that, after controlling for short-term cyclical factors, high rates of economic growth are associated with either declines in informalization or slower rates at which informalization is increasing[17].

17 See Resources section to access: James Heintz and Polin, 2005, "Informalization, economic growth, and the challenge of creating viable labor standards in developing countries", in *Rethinking Informalization*. Neema Kudva and Lourdes Beneria (eds.)

EMERGING APPROACHES AND GOOD PRACTICES

- The need for an integrated approach
- Policy area one: growth strategies and quality employment generation
  - Placing employment at the heart of economic and social policies
  - Reorienting macro-economic policies
  - Monetary and financial sector reform
  - Exchange rate policies
  - Public investment, access to public assets, and fiscal policy
- Sectoral policy
- Policy area two: The Regulatory Environment
- Policy area three: Social dialogue, organization and representation
- Policy area four: Promoting equality and addressing discrimination
- Policy area five: Supporting entrepreneurship development
- Policy areas six: Extending social protection
- Policy area seven: Local development strategies

The previous section has endeavored to show that policies surrounding economic growth are critical to understanding impacts on informality. The following section will respond to the second question posed in the introduction to this brief: what sorts of policies need to be put in place to support and complement economic growth if informality is to be reduced? This section will examine seven broad policies areas which indicate the multiple avenues towards formality (and which also structure this Policy Resource Guide).

The need for an integrated policy approach

Informality manifests itself in very country-specific ways, so the policy mix to support the reduction in informality needs to be adapted to the particular drivers of informality in different labour markets. Experience at country level shows the importance of a number of elements in curbing informality including: ensuring that employment policies are embedded within growth strategies rather than seen as a residual element of economic growth; and developing an explicit strategy aimed at curbing informality. The examples below on Argentina and Brazil – two countries which have successfully curbed informality and have seen a growth in formal job creation in the recent period – exemplify these elements.

Argentina – public policies for reversing informality

Argentina is an example of an explicit strategy developed by the Ministry of Labour, with ILO support, that has succeeded in curbing the trends in increased informality that followed the 2001 economic crisis. In the context of strong employment growth, unregistered salaried employment decreased from 43 percent to 39 percent between 2004 and 2007. Lessons learned include the following:

- the strategy for transition to formality should be embedded in the core of the employment and labour strategy pursued by the Government and not as a stand-alone project;
- the curbing of informality was projected as a major priority and challenge;
- the strategy pursued was consistent with the public policy framework and promoted social partnerships; and
- the implementation has been monitored and evaluated periodically.

The ILO advocated an integrated strategy framed within the Decent Work Country Programme that included six areas: prioritizing employment in the growth strategy; defining a consistent policy and regulatory framework; strengthening labour inspection and labour administration; promoting education and awareness on formalization issues; extending social protection to the informal economy; and promoting social actors and private-public partnerships.

Source: ILO 2010 Employment Policies for social justice and a fair globalization: A recurrent Item Report on Employment, International Labour Conference 99th session 2010 Geneva

Brazil's rise in formalization in the 2000s

During the 1980s and 1990s stagnant growth and economic downturns had seen a swelling of informal economies in many countries in the Latin American region. By the 2000s however Brazil saw a significant reversal in this trend and a rise in formalisation. Several reasons can be attributed to this phenomenon including:

1) Macroeconomic environment
Macroeconomic performance during the 2000s was favourable towards the growth of formal jobs. Analysts have suggested that there is a significant and positive relationship between movements in real exchange rates and the rate of unemployment[18]. The appreciation of the currency during the 1990s gave way to devaluation in 1999. Following the devaluation and until 2005 the real exchange rate remained highly competitive, boosting exports and protecting domestic industries from import competition. New jobs were created, particularly in the export sector, but also the import-competing manufacturing sector. Between 2000-2008 there were significant increases in formal jobs in numerous sectors including mining, agriculture and fishing, and manufacturing.

Importantly there were also strong efforts to ensure the redistribution of the benefits of growth. The Bolsa Familia programme, which covers nearly one quarter of the population, has been an important mechanism in making growth more inclusive. The programme, along with the consumption patterns of the sizeable Brazilian middleclass, has driven internal demand resulting in boosts in consumption and economic growth.

18 Frenkel.R and Ros,J. (2006) Unemployment and the Real Exchange Rate in Latin America World Development 34(4):631-646

2) The Simples law
In 1996 the Government instituted a new system of tax exemption and simplification for small and micro enterprises known as the Simples law. It includes a progressive tax structure and a simplification of tax collection. Analysis suggests that it was responsible for the formalisation of some 500,000 microenterprises between 2000-2005, accounting for 2 million jobs[19]. Formalisation of enterprises led to the creation of virtuous circles: firms could easily register, they then had better access to formal finance and credit, which improved their viability, and because they were legitimate businesses it was more risky for them to not register their workers.

3) Reduced labour supply pressure
Demographic trends have seen a lowering of fertility rates and a reduction of the numbers of youth entering the labour market. The latter not only because of the reduced birth rate but also because of a greater proportion of youth in education.

4) Improved labour inspection and new approaches to Formalization
Improved labour inspection – not as a result of more inspectors but – as a result of changes in incentive structures and new methods for meeting inspection targets were introduced in the mid-1990s. The new system led to an increase in the number of workers registered as a result of inspection.

5) Greater respect for the law
Segments of the informal economy, particularly domestic workers, saw notable increases in formalization during the 1990s despite historical exclusion from labour law coverage. The 1988 Constitution engendered greater respect for the law and placed many workers in a better position to exercise their rights.

The Government of Brazil is also putting in place other measures to support the growing trend towards formalization. These include reduction in the costs of social security contributions of employers of domestic workers, through income tax credits; raising the minimum wage to stimulate domestic demand and the 2009 Individual Entrepreneur Law which facilitates registration of micro enterprises and reduces the cost of social security contributions for the self-employed.

Source: Berg, J. Laws or Luck? Understanding Rising Formality in Brazil in the 2000s. In Regulating for Decent Work: New Directions in labour market regulation (ed. Lee,S. ad McCann,D.) (ILO and Palgrave MacMillan 2011)

What is clear is from the examples of Brazil and Argentina is that ad-hoc policies are unlikely to make a sustained impact on informality. Rather, what is needed is a comprehensive approach across a range of policy areas, and policy coherence between these measures. This comprehensive approach first established through the 2002 International Labour Conference discussion on Decent Work and the Informal Economy – has been refined into seven broad policy areas which indicate the multiple avenues towards formalization. These policy areas are: i) growth strategies, ii) the regulatory framework, iii) social dialogue, organization and representation, iv) promoting equality and addressing discrimination, v) measure to support entrepreneurship, vi) the extension of social protection and vii) local development strategies. Each of these will be addressed here, though the reader is encouraged to examine the more detailed approaches in specific technical briefs within this guide.

19 Delgado, Guilherme, Ana Carolina Querino, André Campos, Fábio Vaz, Leonardo Rangel and Matheus Stivali (2007) "Avaliação do Simples: Implicações à formalização previdenciária," IPEA, Texto para Discussão no. 1277

■ Policy area one: Growth strategies and quality employment generation.

• Placing employment at the heart of economic and social policies. This first policy area covers macro-economic policies to support the transition to formality, including ensuring the centrality of employment policies in macroeconomic frameworks. Curbing the spread of informality means, first and foremost, making employment a central concern of economic and social policies, promoting employment-friendly macroeconomic frameworks and making the productive sectors of the economy a priority target of poverty reduction strategies (PRSs)[20]. Channeling appropriate levels of investments, domestic and foreign into those sectors of the economy that increase labour absorption and improve productivity in the rural and urban economy is a significant part of the response to reducing the growth of informality.

● Macro-economic policies need to be focus on achieving employment growth, poverty reduction as well as macro-economic stability

• Reorienting macro-economic policies Secondly, addressing the issue of the informal economy means reorienting macro-economic policy. There needs to be a focus on achieving employment growth and poverty reduction targets together with macro-economic stability. The explicit goal of the new macro-economic framework should be to raise productivity, facilitate economic transformation, and increase the availability of formal jobs, while improving the ability of workers to do those jobs[21]. Thus macroeconomic policy should focus on creating a supportive environment for employment generation, resource mobilization and allocation and economic transformation. This has implications for Central Bank policy, financial policy and regulation, industrial policy and fiscal policy. It means that Central Bank policy in some countries, for example, could be oriented to be part of the overall coordinated governmental development effort rather than a completely isolated entity, while having sufficient autonomy to ensure its stabilization function [22]. Moreover, the financial sector must become much more supportive of economic development and growth than it is at present.

• Monetary and financial sector reform. The conduct of monetary policy can have a direct impact on two key constraints for informal economy workers: (1) the development of domestic markets and (2) access to productive assets (via credit and financial institutions)[23] To generate better employment opportunities, monetary policy must encourage investment in productive assets, facilitate the development of markets, and maintain macroeconomic stability. Inappropriate monetary policy will constrain economic growth and investment, and, as a result, will hinder efforts to create better employment opportunities. Therefore, it is important to consider what monetary policy regime would best serve the developmental objectives of improving employment and reducing poverty[24]. Restrictive monetary policy can affect the productive potential of the economy by limiting access to and investment in productive resources. Credit and financial services can play an instrumental role in allowing enterprises, including small-scale and informal enterprises, to acquire and accumulate productive assets. Monetary policies that aim to reduce inflation to the lower single digits affect the cost of credit throughout

20 See Heintz, J. and Pollin, R. (2008), Targeting employment expansion, economic growth and development in Sub-Saharan Africa: Outlines for an alternative economic programme for the region (Addis Ababa: UNRCA).

21 See ILO, 2009, The informal economy in Africa: Promoting transition to formality – Challenges and strategies (Geneva: ILO), p.21

22 See Epstein, G.; Heintz, J. ; Ndikumana, L. and Chang, G. (2009), Employment, Poverty and Economic Development in Madagascar: A Macroeconomic Framework, Enployment Sector WP Series (Geneva: ILO)

23 See J. Heintz, 2009, Employment, Poverty, and Economic Policy in the Context of Widespread Informality, Employment Sector WP Series (Geneva: ILO), p.10.

24 See G. Epstein, 2009, Rethinking Monetary and Financial Policy, Employment Sector WP Series, no.37 (Geneva: ILO)

the economy as it raises real interest rates. Credit rationing is pervasive in most developing countries and constraints on the growth of credit, imposed by a restrictive monetary regime, can exacerbate this problem. Macroeconomic tools, such as asset-based reserve requirements, development banking, and loan guarantees, should be made available to support priority sectors with a high employment multiplier, both to direct investments and to mobilize resources for high-value-added, high-employment sectors.

• **Exchange rate policies.** Considering the heterogeneity of the informal economy, the effect of an exchange rate policy can be ambiguous on actors in the informal economy. A competitive exchange rate through managed devaluations could hurt the living standards of informal economy retailers of imported goods, particularly if they cannot pass on the cost increases as higher prices or if demand for their products is highly sensitive to price movements. Meanwhile, informal firms could benefit from a competitive devaluation if they supply specific goods and services to export-oriented or import-competing sectors. Similarly, an exchange rate regime that maintains a competitive rate could indirectly support faster growth of the domestic market, if export-oriented sectors and/or import-competing sectors are an important source of income for other segments of the labour market. In this case, the growth of these sectors could also lead to the growth of the domestic market, as incomes and purchasing power grow.

• **Public investment, access to public assets, and taxation policy.** Public investment is central for raising productivity, improving access to markets, and reducing spatial barriers to mobility. A poor economic infrastructure and limited access to public services increases the operating costs of informal firms, limits their ability to meet quality standards, reduces their access to markets and their productivity (as a consequence of poor health and education levels) . In terms of financing such investments, the national budget is the primary developmental instrument which governments have under their control. Moreover, labour-based approaches to infrastructure works have become an important element of job creation strategies in many low-wage developing countries with an oversupply of underemployed labour. Well-managed labour-based methods have proven to be a viable and cost-effective alternative to equipment-based methods because they produce good quality results, allow cost savings – particularly in terms of foreign exchange – and can generate high levels of outputs, provided that they are introduced in an appropriate institutional setting[25]. Electrification, rural roads, health and education centers or market spaces have an impact on private productivity, and earnings of small-scale producers. The issue of productivity is important because the level of productivity will ultimately limit individual earnings and household living standards. Therefore, barriers to improving the productivity and earnings potential of informal workers present one set of factors that keep incomes low. Productivity improvements are necessary, but not sufficient, for sustainable increases in living standards. Productivity improvements will not raise earnings if, for example, such improvements lead to less favorable terms of trade for the informal self-employed due to adverse price adjustments. Nevertheless, productivity improvements make higher earnings possible.

With regard to taxation policies, policy makers need to develop the types of appropriate measures which will not overburden different types of enterprises such as micro, small and medium sized enterprises. Tax holidays and progressive taxation systems which enable lower taxes for smaller

25 See David Tajgman and Jan de Veen, 1998, Employment-Intensive Infrastructure Programmes: Labour Policies and Practices (Geneva: ILO)

enterprises are an important part of a policy framework to support the move out of informality. The case of Brazil's Simples Law (see box on Brazil) is a good example of the taxation policy which is tailored to the needs of different sized enterprises to encourage compliance with fiscal regulations.

■ Sectoral policy

Taking a sectoral and sub-sectoral approach to encouraging the move out of informality can help clearly identify those sectors and sub-sectors where informality is particularly prevalent, for example in agriculture and services, and develop appropriate policy responses. Many countries for example, particularly in Latin America, have been developing measures to bring the domestic services sub-sector under the protection of the law, and hence promoting the transition to formality.

A sectoral approach is also important in identifying particularly dynamic and growth-oriented sectors for national policy support. In pursuit of the objective of ensuring full and productive employment many developing countries face a wide range of fundamental policy questions including: *What should be the priority sectors for potential job creation? What key industrial policy measures and reforms could accelerate job-rich growth?* Countries are developing new analytical and policy frameworks to explore constraints on and opportunities for enhancing (i) the employment content of growth and (ii) the extent to which the working poor and the unemployed are able to access the benefits from economic development[26].

To promote job-oriented patterns of growth it is crucial to provide an overview of the structure of employment in each sector and some key information about: (i) employment creation potential within each sector and (ii) upstream and downstream linkages for a better understanding of the role of each sector in employment creation. Rigorous analysis is data dependent and often draws from input-output tables, and Social Accounting Matrices (where they have been built). In doing this, it is recognized that the opportunity to intensify job rich growth at the country level is seldom uniform across an entire economy. Economic sectors vary, and their performance is often mutually dependent on social sectors, such as education, for the provision of skilled labour to meet market demand or health.

■ Policy area two: The Regulatory Environment

Another essential policy area for addressing informality is the regulatory environment. Labour regulation stands at the heart of the policy debate surrounding the growth of informality. For some analysts government regulations on the labour market are seen to impose excessive costs and constraints on economic actors who in turn seek to avoid these costs by operating in the informal economy. In this view the transaction costs of the formal economy for small firms and the self-employed are likely to exceed the benefits these firms derive from the legal system. However, as firms grow in size or become more capital-intensive the need to participate in institutions that protect property, enforce contracts, provide access to low cost credit or pool risk, grows. When the benefits of formality outweigh the costs, rates of informality are likely to decline[27]. This approach can provide useful insights into how a prevailing regulatory environment can influence the growth of informality, but it is undermined by the historical conditions in

26 See for instance "Impact assessment at the sector level", in section 3, ILO (2009), Country level rapid impact assessment of crisis on employment – A guide (Geneva: ILO)

27 Heintz and Pollin 2005. Proponents of this view include Levenson and Maloney 1998, Loayza 1996; Srte 2000, de Soto 2000)

which informality rose during the 1980s – 1990s. That is, that this was precisely the period in which labour market regulations in developing countries were declining, that informality was at the same time rising during these two decades[28] .

On the other side of the debate are those who see the rise in informality during this same period as a result of the pervasiveness of neo-classical economic models of the time: a decline in government regulations in both financial and labour markets; privatization, reduced barriers to free trade, and macroeconomic policies oriented towards inflation targeting rather than full employment. In this view, the combination of these policy measures resulted in the strong growth of the informal economy during the period under question[29]. The policy mix to reverse informalization therefore must take into account ensuring good governance in the labour market through effective and appropriate labour regulation adapted to specific country contexts. This is an approach which is very much in line with the Decent Work Agenda, in which ensuring the rights and recognition of workers, the self-employed and employers who are currently unprotected in the informal economy, is seen as a major step out of informality. The examples from Argentina and Brazil provide evidence that reducing informality was not brought about through systematic labour-market deregulation, but rather through better and more effective regulation. For more details see the technical briefs under the Regulatory Environment section.

■ Policy area three: Social dialogue, organization and representation

The policy mix supporting the reduction of informality and poverty requires an environment where social dialogue can flourish. Social dialogue underpins good governance and democratic decision making in the labour market. Policy formulation on the informal economy requires that actors in the informal economy are able to organize, articulate their needs and rights, and engage effectively within social dialogue platforms. Governments have a key role to play in setting the enabling framework for social dialogue, including ensuring the fundamental rights of freedom of association and the right to collective bargaining. For more details see specific technical briefs under the thematic area of Social dialogue, organization and representation.

■ Policy area four: Promoting equality and addressing discrimination

Curbing informality means addressing the factors which push many vulnerable groups into the informal economy. Labour market discrimination against poorer women, youth, disabled, ethnic groups, migrant groups often results in these groups being concentrated in the informal economy. Policy and legal frameworks need to eliminate discrimination in the formal labour market and open access to the formal economy through targeted strategies in all policy areas. Both mainstreaming strategies and specifically targeted policies may be required to ensure more effective functioning of labour markets and facilitate the opening of opportunities for vulnerable groups to move out of informality. For more details see technical briefs under the thematic area of Promoting Equality and Addressing Discrimination.

28 See Resources section to access: Heintz,J. and Pollin,R. 2005.
29 ibid

■ Policy area five: Supporting entrepreneurship development

Entrepreneurship is one of the largest sources of employment in developing countries, but these enterprises are often in the informal economy. The challenge for policy makers is to address the heterogeneity of informal enterprises, and to provide the correct balance of incentives for transitioning to formality and disincentives for remaining informal. An enabling environment for reducing the numbers of informal enterprises includes, but is not limited to: establishing simplified, streamlined and cost effective registration procedures; capacity building of enterprises to enable compliance with regulations and improve working conditions; fiscal incentives; opening access to skills training, microfinance, business advisory services, market information, technology, productive resources, social protection and trade opportunities. For more details see the technical briefs under the section Entrepreneurship, Skills, Finance.

■ Policy area six: Extension of social protection

A defining feature of informality is the limited or lack of access to social protection. Instruments to mitigate risks can have major impacts on both poverty reduction and on reducing informality. Social protection is a means of redistributing the gains of economic growth and they are a vital part of strengthening aggregate demand and alleviating poverty risks. A range of instruments are available which are often used in different combinations to reach the most vulnerable segments of society located within the informal economy.

Social protection, both in the form of insurances against risks and in the form of income stabilization policies such as employment guarantee schemes have numerous multiplier effects in the local economy. It increases the disposable incomes for households, reduces vulnerability to shocks, stimulates demand for products and services in the local economy, which in turn can increase employment and incomes within poor communities.

The ILO's recent Recommendation on social protection: *Recommendation concerning national floors for social protection 2012 (No.202)* makes clear reference that social security strategies should apply to persons both in the formal and the informal economy and support the growth of formal employment and the reduction of informal employment[30].

Various social protection measures in different countries are having great impact on reducing vulnerability in the informal economy. For example India is moving towards minimum social security coverage for all informal workers[31] and at the same time has set up a National Rural Employment Guarantee scheme which offers up to 100 days of work. Both strategies will significantly reduce vulnerability in poor households. Ghana and Thailand have both put in place significant measures to expand the scope of health coverage to the informal economy[32] while Argentina, Chile and Uruguay are amongst many countries seeking to reduce vulnerabilities for the self-employed[33]. Brazil has set up Bolsa Familia and other instruments which cover a large proportion of Brazilian society. For more details of these and other measures see the technical briefs under the thematic area of social protection.

30 For more details of the Recommendation see http://www.ilo.org/wcmsp5/groups/public/---ed_norm/---relconf/documents/meetingdocument/wcms_183326.pdf

31 See Resources section to access: ILO (2008), The transition to formalization: Recent trends, Policy debates and good practices on the informal economy, Proceedings of the Tripartite Interregional Symposium on the Informal Economy: Enabling Transition to Formalization, (Geneva: ILO), p.10.

32 See brief on social security for details

33 See Resources section to access: ILO (2008), The transition to formalization: Recent trends, Policy debates and good practices on the informal economy, Proceedings of the Tripartite Interregional Symposium on the Informal Economy: Enabling Transition to Formalization, (Geneva: ILO),

■ Policy area seven: Local development strategies

The last broad policy area covers local development strategies. These offer an important opportunity to translate national priorities for supporting the transition to formality to the local level. Integrated strategies for moving out of informality, based on social dialogue, are more readily implementable at the local level. A range of strategies can be incorporated into local development strategies such as setting up basic infrastructure, supporting Small and Micro Enterprise development, streamlining registration and zoning regulations, facilitating public contracts and tendering processes, fostering public-private partnerships, supporting market access, targeting disadvantaged groups and using labour intensive methodologies. The combinations of these and other tools can have a major impact in supporting the move out of informality at the local level. For more details see the technical briefs under thematic area of Local Economic Development.

These seven policy areas described above need to be adapted to the root causes and specificities of informality as they manifest themselves in individual countries. The policy areas identify the broad and multiple avenues towards formality, and they indicate the range of policies which can support and complement economic growth to enable it to effectively reduce the informal economy. Without them the impact that economic growth will have on reducing informality will be minimal.

Child vendor, Moldova

RESOURCES

This section provides a list of resources to enable the reader to delve deeper into the issue. A bibliography of references in the text is further below. There may be some overlap between the two.

ILO Instruments and ILC Conference Conclusions

Employment Policy Convention, 1964 (No.122)
http://www.ilo.org/ilolex/cgi-lex/convde.pl?C122
Employment Promotion and Protection against Unemployment Convention, 1988 (No.168)
http://www.ilo.org/ilolex/cgi-lex/convde.pl?C168
NB: Numerous International Labour Standards make implicit and explicit reference to the informal economy. The reader will find more information in specific briefs within this Guide.

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http://www.ilo.org/wcmsp5/groups/public/@ed_emp/@emp_policy/documents/meetingdocument/wcms_125519.pdf

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Contents: