

# Persisting Informal Employment: What Explains It?

David Kucera  
Decent Work Forum XXXI  
December 12, 2008

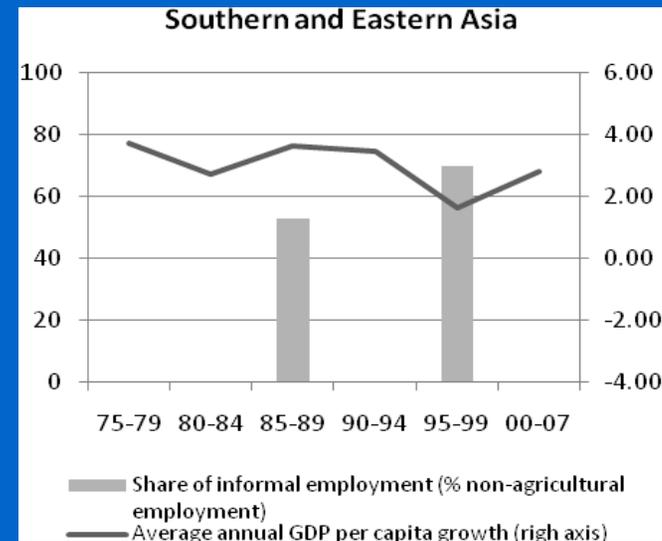
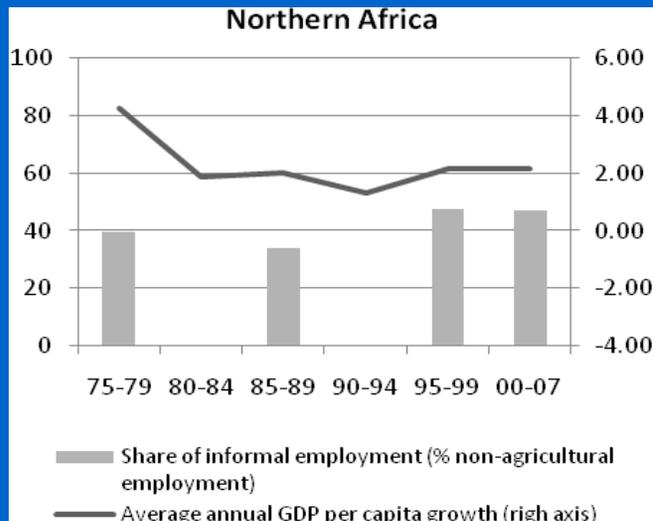
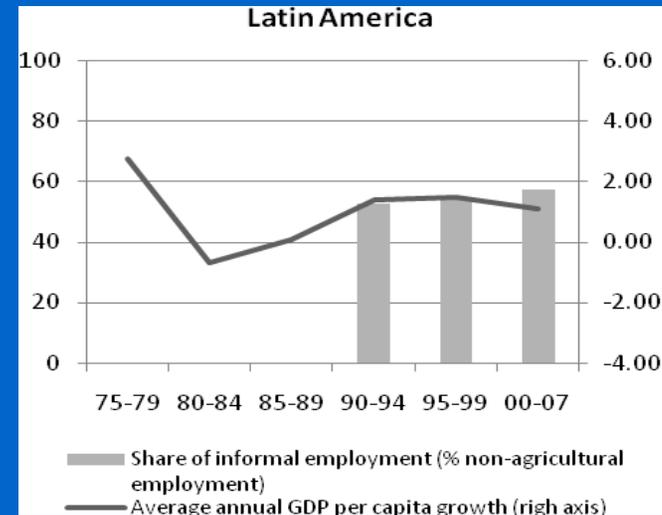
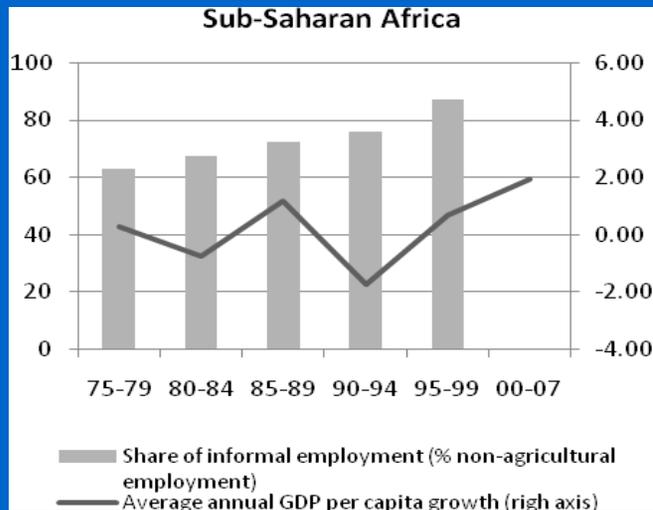
# Presentation Overview

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

# Cross-country patterns suggest that the share of informal employment declines alongside economic growth...



# ...Yet in recent years, informal employment has persisted in the face of economic growth



# Why does informal employment persist?

## Theoretical foundations

- **Harris-Todaro (1970) versus Lewis (1954) Models of dual labour markets for developing countries**

## Most models of formal-informal employment dynamics are based on the Harris-Todaro Model

*“The distinguishing feature of this model is that [rural-urban] migration proceeds in response to urban-rural differences in expected earnings...with the urban unemployment [i.e., informal employment] rate acting as an equilibrating force on such migration.”*

## **Paradox:**

In the Harris-Todaro model, more formal employment and urbanization result in more informal employment

## **Two-fold policy package:**

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

**Emphasis on rural poverty and development**

## Dilemma for Harris-Todaro model as a general model for developing countries

- Economic growth is characterized by urbanization. *Without urbanization, no economic growth.*
- Harris-Todaro model does not provide a clear path to long-run relationship between higher GDP/capita and lower shares of informal employment

- In the Lewis Model the shift of unskilled workers from the informal (“subsistence”) sector to the formal (“capitalist”) sector is constrained by the number of jobs in the formal sector, which is in turn constrained by the scarcity of formal sector capital

Lewis model provides a more useful foundation for evaluating formal-informal employment dynamics

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

# New developments

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

- Informal employment in formal establishments (2003 ILO Definition)
- Informal employment in global commodity chains

# Data on emerging forms of informal employment is scarce

- Anecdotal evidence suggests it is growing alongside other forms of irregular, precarious employment
- E.g., Posthuma and Nathan (2009) find informal employment throughout global commodity chains, in upper and lower tiers

To what extent have these developments weakened the linkage between economic growth and declining informal employment?

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

*Economic growth is not enough*

## II. The Effect of Labour Market Regulations on Informal Employment

*Informality: Exit and Exclusion, World Bank  
(2007)*

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

## ***Law and Employment: Lessons from Latin America and the Caribbean – J. Heckman and C. Pagés (2004)***

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

### Results:

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

But what are the implications of job security costs for *informal* employment?...

...consider the case of Peru

**“Labor Market Reforms and Their Impact over Formal Labor Demand and Job Market Turnover: The Case of Peru” - J. Saavedra and M. Torero (2004)**

- Job security costs fell while formal employment increased in Peru in the 1990s.
- However, informal employment increased even more rapidly, with the result that falling job security costs occurred alongside a *rising* share of informal employment.

Results for Peru are typical for the region...

# “The Cost of Job Security Regulation: Evidence from Latin American Labor Markets” – J. Heckman and C. Pagés-Serra (2000)

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

Model of: Share of self-employment

Key explanatory variable: Job security index

Results:

	OLS	Fixed effects
OECD plus LAC	1.37 (5%)	-8.43 (1%)
LAC	1.09 (10%)	-8.34 (1%)

# “The Determinants of Rising Informality in Brazil: Evidence from Gross Worker Flows” – M. Bosch, E. Goni and W. Maloney (2007)

Description: Cross-industry panel data analysis, 1983-2002

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

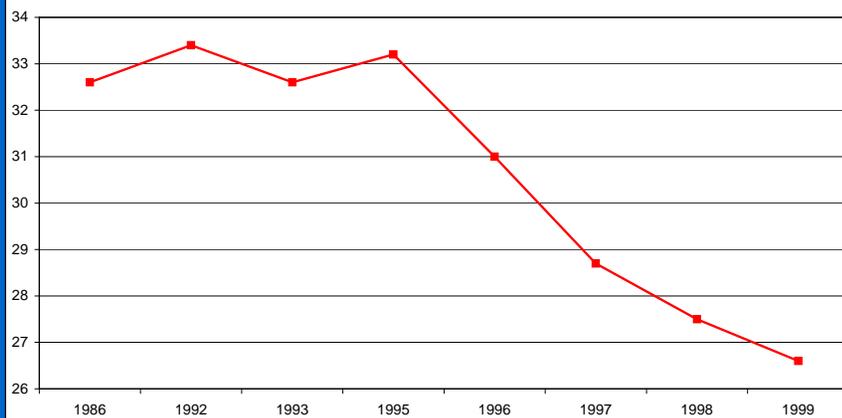
Key explanatory variables: % of unionized workers, labour costs

Results:

- Greater unionization is associated with higher shares of formal employment
- Estimated positive and negative effects on formal job creation and destruction cancel each other over time

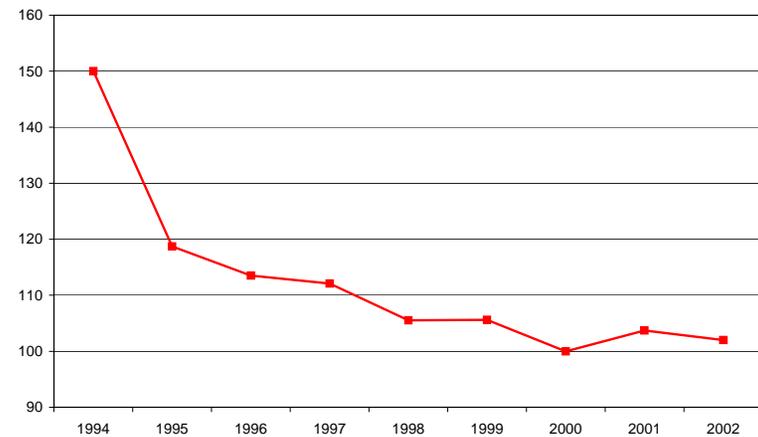
The authors conclude that the increase in informal employment in Brazil in the 1990s resulted from “*increases in union power*” and “*rising labor costs*”

Fig. 4: Union Enrollment Rate, Brazil, 1986-1999



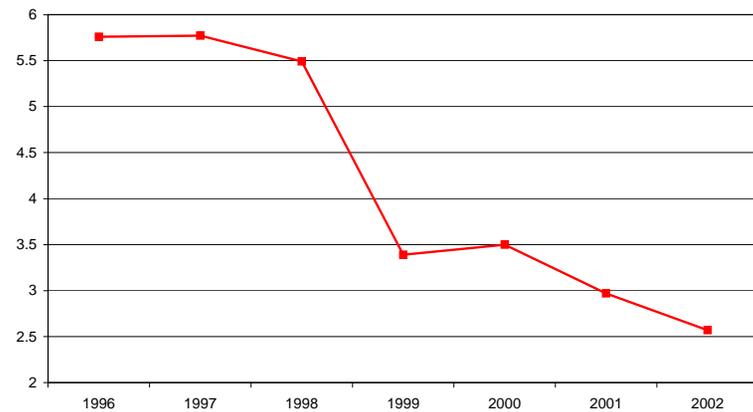
Source: Bosch, Goni, and Maloney (2007)

Fig. 5: Real Manufacturing Wage Index, Brazil, 1994-2002 (2000 = 100)



Source: ILO, Key Indicators of the Labour Market, 5th Ed., 2007

Fig. 6: Hourly Compensation Costs in Manufacturing (wage plus non-wage), US dollars, Brazil, 1996-2002



Source: ILO, Key Indicators of the Labour Market, 5th Ed., 2007

Given what is at stake for workers in developing countries, advocates of weakening of labour regulations as a policy to reduce informal employment ought to hold themselves to a high technical standard

***This standard has not been met***

## *Concluding remarks*

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

Contrary to:

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

## *Concluding remarks cont'd...*

- Emerging forms of informal employment appear to have weakened the linkage between economic growth and declining informal employment
- The empirical evidence suggests that labour market regulations are not generally a cause of persisting informal employment
- The debate on labour regulations should not be about regulation versus deregulation, but about the optimal design and implementation of labour regulations