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Informality and work status

Gary S. Fields*

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Abstract: The most important determinant of households' livelihoods is how much they earn for their labour. People in informal work are more likely to be low earners, to live in poverty, and to make fewer transitions into the higher-paying work statuses. The paper is divided into three main sections: what we mean by informality and work status, why we should differentiate between work statuses, and what we can learn by analysing work statuses and transitions between them.

Key words: informal work, work status, livelihoods, poverty, transitions

JEL classification: J3, J6, O1, O2

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* Cornell University, Ithaca, NY; Institute of Labor Economics (IZA), Bonn, Germany; and UNU-WIDER; email: gfsf2@cornell.edu

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Katajanokanlaituri 6 B, 00160 Helsinki, Finland

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1 Informality and work status: what do we mean?

1.1 Informality and its components

For purposes of this paper, ‘informality’ is conceptualized as a general notion. It can be thought of as a job-based concept or an enterprise-based concept (ILO 2019). Informality in this paper is a catch-all term referring to the informal economy, informal sector, informal employment, and formality/informality status.

I am not alone in bemoaning the lack of terminological precision. Guha-Khasnobis et al. 2006: 2–3) write:

Given the prominence of the formal–informal dichotomy in the development discourse, one might expect to see a clear definition of the concepts, consistently applied across the whole range of theoretical, empirical, and policy analyses. We find no such thing. Instead, it turns out that formal and informal are better thought of as metaphors that conjure up a mental picture of whatever the user has in mind at that particular time.

Still, we can clarify a number of ideas.

The definition of *informal economy* by Women in Informal Employment: Globalizing and Organizing (WIEGO), the International Conference of Labor Statisticians (ICLS), and the International Labor Organization (ILO) is ‘the diversified set of economic activities, enterprises, jobs, and workers that are not regulated or protected by the state’ (WIEGO 2020).

A second concept is the *informal sector*. The informal sector is defined as ‘units or enterprises that are not registered in the statistical or tax institutions and do not keep written accounts’ (Herrera et al. 2012).

Because the Transforming Informal Work and Livelihoods Project of the United Nations University World Institute for Development Economics Research (UNU-WIDER) has adopted a job-based concept of informality rather than an enterprise-based one, the term informal sector will be used only in passing in this paper.

A third concept is *informal employment*. Informal employment is of two kinds (ILO 2018):

- (1) self-employment in informal enterprises (small unregistered or unincorporated enterprises) including: employers, own account operators and unpaid family workers in informal enterprises; and
- (2) paid employment (or what, in this paper, is called wage employment) in informal jobs (for informal enterprises, formal enterprises, households, or no fixed employer) including: casual or day laborers, industrial outworkers, unregistered or undeclared workers, contract workers and unprotected temporary and part-time workers.

Accordingly, the UNU-WIDER project formulates informal employment as a job-based concept consisting of ‘all remunerative work (i.e. both self-employment and wage employment), that is not registered, regulated or protected by existing legal or regulatory frameworks, as well as non-remunerative work undertaken in an income-producing enterprise’ (ILO 2019).

To illustrate the importance of choosing the precise notion of informality, take the case of India. There, the terms ‘organized sector’ and ‘unorganized sector’ are used in place of the more common ‘formal sector’ and ‘informal sector’ , respectively. Data show that half the number of people working in formal sector entities in India (including firms, government office, etc.) are themselves employed informally in the sense of not being registered with the government or receiving the protections that others in the same workplaces receive (NCEUS 2009).

The UNU-WIDER project is concerned with informal employment. Although many of the informally employed are in the informal sector, many others are in the formal sector. Conversely, many but not all of the formally employed are in the formal sector; some are formally employed in the informal sector. Since our concern is with people working informally, we should focus on informal employment, recognizing that not all of it is in the informal sector.

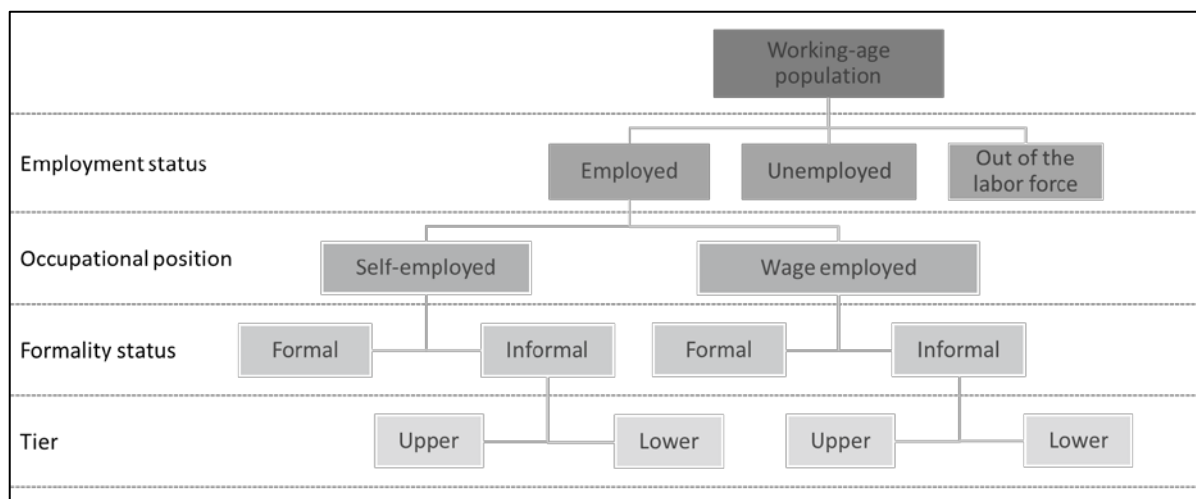
Data from ILO (2018) and WIEGO (see Bonnet et al. 2019) show that 2 billion of the world’s employed population aged 15 years and above work informally. This represents 61.2 per cent of global employment. Regions with above-average rates of informal employment are Africa (85.8 per cent), Asia and the Pacific (68.2 per cent), and the Arab states (68.6 per cent).

1.2 Work status

The UNU-WIDER project uses the term ‘work status’ to denote the kind of employment in which a worker is engaged. This project adopts a multi-faceted categorization scheme, not just a single classifying variable. Four variables—employment status, occupational position, formality status, and upper/lower tier—are used to determine work status. Each is defined in Section 2.

As examples, the studies by Danquah et al. (2019) on four African countries and by Alaniz et al. (2020) on Costa Rica and Nicaragua adopt the schema shown in Figure 1.

Figure 1: A six-way work status classification



Source: reproduced from Raj et al. (2020: 4), under the Creative Commons licence CC BY-NC-SA 3.0 IGO.

Using these variables, the result is a six-category work status variable:

- formally self-employed;
- formally wage-employed;
- upper-tier informally self-employed;
- lower-tier informally self-employed;

- upper-tier informally wage-employed;
- lower-tier informally wage-employed.

The remainder of this paper discusses how these work statuses might be used fruitfully.

2 Differentiating between the work statuses

2.1 Limitations of employment versus unemployment

The usual starting points for assessing an individual's labour market status are whether or not that individual is in the labour force and whether or not that individual is employed. Individuals are defined as being in the labour force if they are working or looking for work. Individuals who are neither working nor looking for work are defined as being out of the labour force. This project focuses on individuals who are in the labour force.

For the labour market as a whole, the first measure reported by statistical offices and used by many analysts to indicate the goodness or badness of labour market conditions is the *unemployment rate*. The unemployment rate is the number unemployed taken as a percentage of the labour force (note that this is *not* the working-age population). At the time of writing, the unemployment rate tells a terrible story: in recent months, countries throughout the world have experienced unemployment rates not seen since the Great Depression, from which they are only slowly recovering.

The unemployment rate, as important as it is, is not the whole story. The reason becomes clear once one understands the definition of employment. By ILO guidance and standard international statistical conventions, individuals are counted as employed if they worked 1 hour or more for pay or 15 hours or more not for pay in the reference week covered by the survey. Thus, only some of those employed are fully and gainfully employed; others work less than full time, work fewer hours than they want to work, and/or earn so little per hour that, despite working a standard work week or more, they do not earn enough to be able to achieve an adequate standard of living. Thus, countries around the world including the developing countries face an *employment problem* consisting of unemployment plus inadequate quality of employment as gauged by the preceding indicators. The ILO reckons that the number of working poor in the world is far greater than the number of unemployed: 700 million working poor in 2018 compared with 173 million unemployed (ILO 2019).¹

A finer categorization of work statuses other than employed versus unemployed provides the kind of fine-grained picture needed to analyse the employment problem that countries throughout the world now face. This categorization is developed in the next section.

2.2 Key distinctions among work statuses

As already noted, the UNU-WIDER project defines work status categories according to employment status, occupational position, formality status, and tier. They are distinguished as follows.

¹ Figures since the start of the COVID-19 pandemic were not available on the ILO website as of 4 November 2020.

Employment status and occupational position

The project classifies workers according to occupational position, separating the wage-employed from the self-employed. It is important to do this because (i) wage employees experience an employer–employee relationship, which the self-employed do not, and (ii) policy interventions that might be suited for one of these groups are inapplicable to others. For example, maximum hours and minimum wage legislation can perhaps be enacted for wage employees but they cannot be applied to the self-employed. If I am self-employed, how can the government order me to pay myself a specified minimum amount?

Formality status

Formality status—whether formally or informally employed—matters most importantly for understanding which work statuses have more social protections than others. In the past, definitions and measurements varied widely across countries (Charmes 2009). More recently, though, attempts at standardization have been made (ILO 2019: 10–12). Still, most country studies operationalize the informality variable using what is available in the country’s household surveys. Examples in the literature are whether the worker has a work card in Brazil, whether the worker is registered with the social security system in Mexico, and whether the job provides for pension benefits in Argentina. Following this lead, the country studies in this project use country-specific definitions.

It should be noted that formality status and occupational position are two different things. Formal does not equal wage-employed, nor does informal equal self-employed, as has been done in some previous research (e.g., Kucera and Roncolato 2008). Those of us who write about these things need to be careful to clarify which of them we are talking about.

Upper-tier informality versus lower-tier informality

A third key distinction is the division within informality between upper-tier and lower-tier informal employment. Early work in the 1970s and 1980s conceived of informal work as essentially a free-entry option at the bottom end of the employment distribution; examples are the four ILO country reports evaluated by Thorbecke (1973), the books by Turnham (1971) and Squire (1981), and the theoretical model by Fields (1975). Later research, however, distinguished a second category of informal employment: informal work that required human capital and/or financial capital and could not be entered freely (Fields 1990, an excerpt of which was also published in Fields 2019a), which advocated for the essential duality of informal employment along free-entry/restricted-entry lines.²

2.3 Underlying labour market models

Today, the bare minimum of four categories are necessary for understanding developing country labour markets. For example, a recent theoretical model has three employment states—wage employment, free-entry self-employment, and high-wage self-employment—plus an unemployment category (Basu et al. 2019). Having two types of informal work (or, alternatively, two types of self-employment) is essential to capture the reality that some workers are engaged in informal employment, not because they *have* to be but because they *want* to be.

² For a more recent review along similar lines, see Kanbur (2017).

The most important reason for drawing the distinction between upper- and lower-tier work is where they lie along a job ladder. The job ladder may be based on such factors as labour market earnings, non-wage benefits, workplace protections and regulations, or some combination of these. Regardless of which components one chooses to focus on, lower-tier work can be thought of as being *below* formal wage employment on the job ladder, while upper-tier informal work may be *above* formal wage employment for some workers (though not all); for example, those with a particular skill or taste for entrepreneurship or self-employment.

At the very bottom of a typical job ladder in a developing country is unemployment, that is, not working at all. Many of those who work informally—the majority, I think—do so because in the countries in which they live, unemployment insurance is limited or non-existent, and consequently being unemployed means having no income. These workers have no choice but to take whatever they can. But there are some—primarily the well-educated and young people in well-to-do families—who can afford to remain unemployed for longer periods of time while searching for good jobs. This was long ago termed the ‘luxury unemployment hypothesis’ (Turnham 1971) and has been re-established over the years (e.g., Udall and Sinclair 1982; Ghose 2003).

Lower-tier informal workers have been given a variety of names, including penniless entrepreneurs (Banerjee and Duflo 2007), reluctant entrepreneurs (Banerjee and Duflo 2011), entrepreneurs out of necessity (Poschke 2013), engaged in informality as a survival strategy (LaPorta and Shleifer 2014), and a strategy of last resort (Günther and Launov 2011).

The literature offers two competing views of why people are working informally. The free-choice view is that all workers can choose whether or not to work formally, and the division of workers between formal and informal employment reflects these choices. Reasons for choosing one versus another include comparative advantage, heterogeneous preferences for independent work, the wish by some to avoid payroll taxes, and other expensive regulations. The segmented labour market view is that the number of jobs in wage employment is limited relative to the size of the labour force, and so even if all wage employment jobs were to be filled, much of the labour force would be rationed out of such jobs. Maloney (1999, 2004) and Levy (2008, 2018) emphasize the first view, while Fields (2009, 2019b) and Basu (1997) emphasize the second.

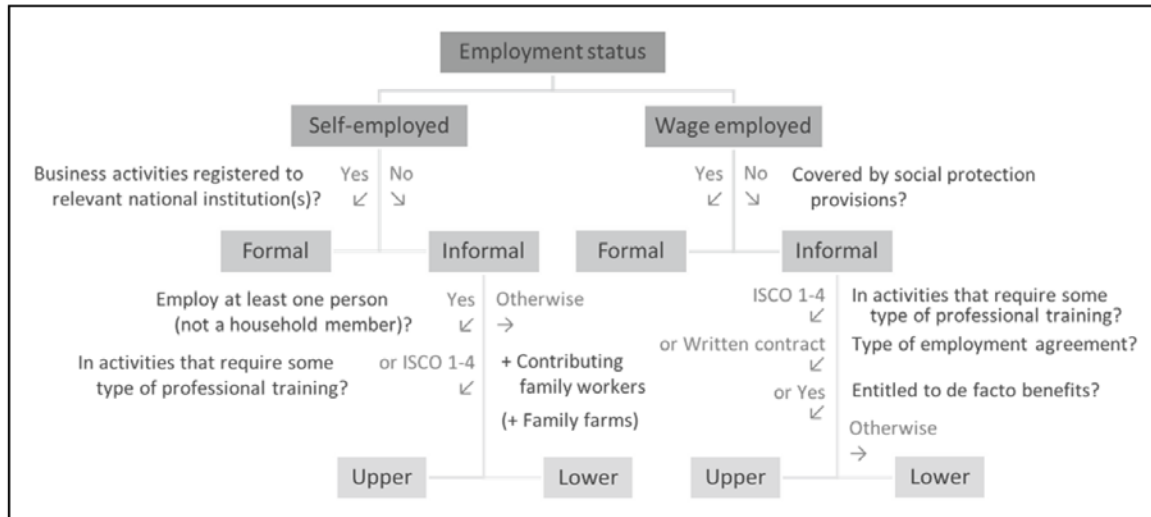
Empirical studies support a mix of reasons, with the weight being about in the middle. Banerjee and Duflo (2011) studied poor workers in 18 developing countries and found that half of the extremely poor in urban areas operate a non-agricultural business. Their interpretation is this: ‘Perhaps the many businesses of the poor are less a testimony to their entrepreneurial spirit than a symptom of the dramatic failure of the economies in which they live to provide them with something better’ (Banerjee and Duflo 2011: 226). Another study concludes that two-thirds of self-employment in the developing world as a whole results from individuals having no better alternatives (Margolis 2014). Another finds an approximately equal split in non-OECD countries (Poschke 2013). Yet another study finds that about half of those working informally in the case of Côte d’Ivoire are doing so by choice and the other half not (Günther and Launov 2011). A World Bank study of Latin America concludes that the majority of independent workers are informal largely voluntarily, whereas the majority of informal salaried workers appear to be involuntary (Perry et al. 2007).³

³ See also the empirical studies reviewed in Basu et al. (2019).

2.4 Classifying workers into work statuses

The authors of the country studies for the UNU-WIDER project were given discretion on how to make use of the preceding variables to devise their own work status categories. Figure 2 is a flow chart displaying how Danquah et al. (2019) used occupational position, formality status, and tier to assign individuals to work statuses.

Figure 2: Rules for assigning workers in Ghana, South Africa, Tanzania, and Uganda to work statuses



Source: reproduced from Danquah et al. (2019: 7), under the Creative Commons licence CC BY-NC-SA 3.0 IGO.

Now, let us turn to some of the lessons learned by analysing work statuses.

3 Analysis of work statuses

3.1 Learning from a single cross section

In a typical labour market study, we know the percentage of workers in each work status. Knowledge of these so-called state probabilities provides an essential snapshot of the kinds of work people are doing at a point in time. We learn, for example, that most workers in developing country are self-employed rather than wage-employed, that the percentage working in agriculture is much higher than the percentage working in services or manufacturing, and that the percentage working informally is much higher than the percentage working formally (Fields 2012, 2019b; ILO 2018). Note, though, that these patterns differ by region of the world, which links closely to per capita gross domestic product (GDP); differences between (i) East Asia, (ii) Latin America, and (iii) Sub-Saharan Africa and South Asia can be understood accordingly (Gindling and Newhouse 2014; Merotto et al. 2018).

Of course, some job categories are better on average than others across a variety of measures, including earnings, social protection, and stability of employment. A single cross section for a given country can tell us which categories are the better ones. Note that different measures may give different rankings: for example, individuals working in the public sector may have greater job security but lower pay than they might have in the private sector. Revealed preference suggests that such rankings vary across individuals within the same country.

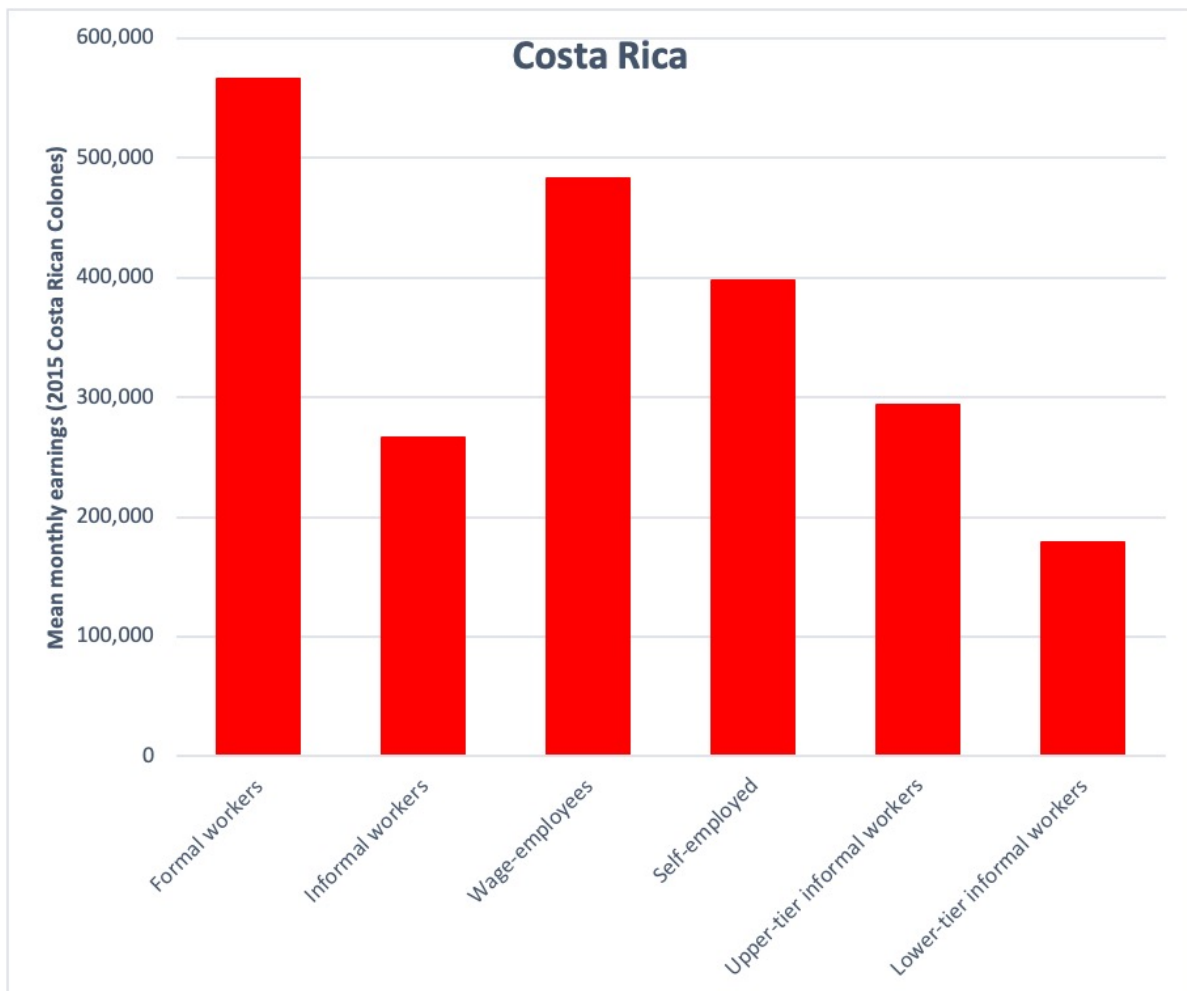
Taking Costa Rica as a case study and focusing on labour market earnings, let us look at six aggregate groups:

- formally employed, regardless of occupational position and tier;
- informally employed, regardless of occupational position and tier;
- wage-employed, regardless of formality status and tier;
- self-employed, regardless of formality status and tier;
- upper-tier informal workers, regardless of occupational position;
- lower-tier informal workers, regardless of occupational position.

Comparing these aggregates, we see the following in Figure 3:

- Formally employed workers earn more than informally employed workers.
- Wage-employed workers earn more on average than the self-employed.
- Upper-tier informal workers earn more than lower-tier informal workers.

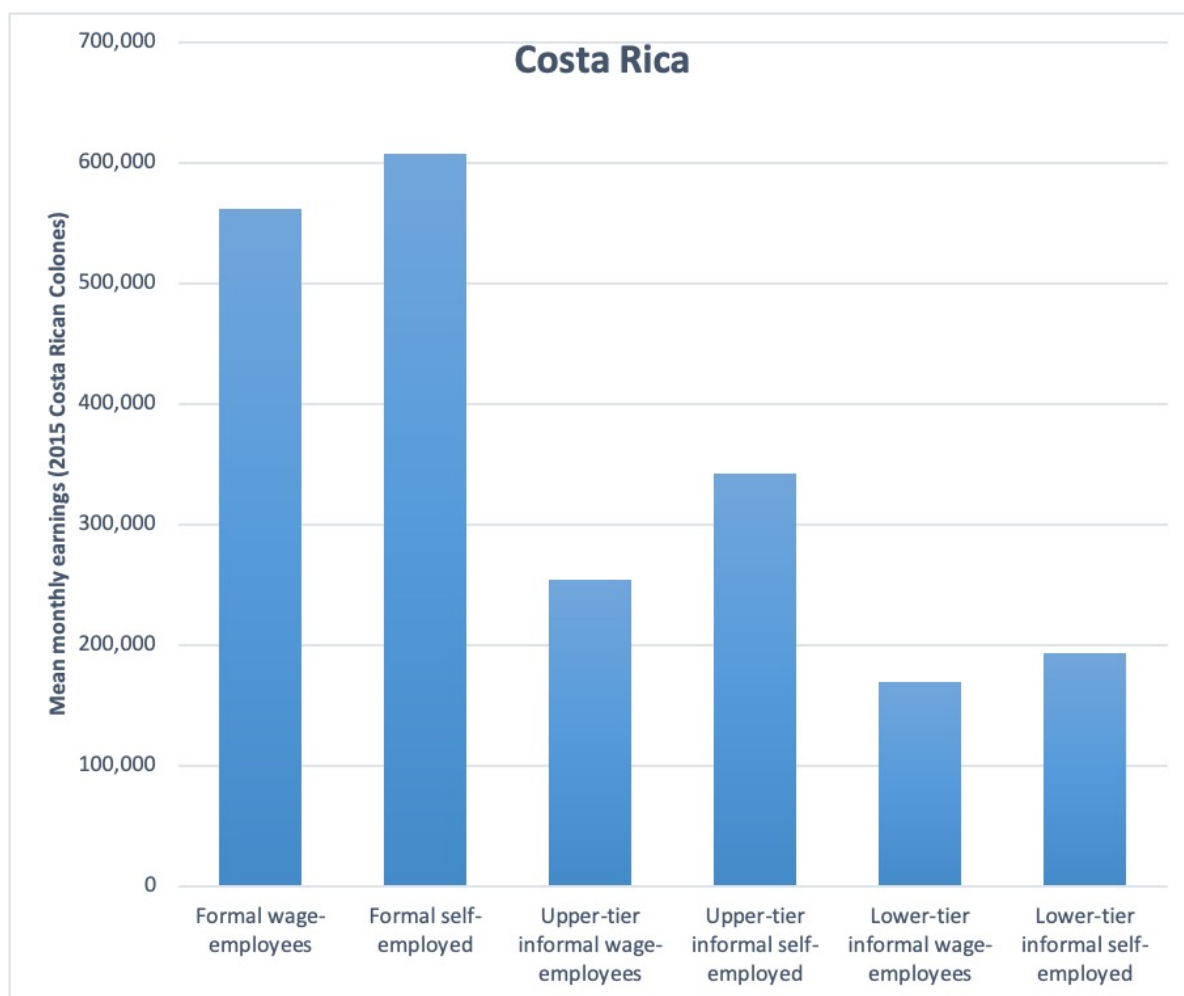
Figure 3: Mean earnings across six aggregates: Costa Rica



Source: tabulation provided by T.H. Gindling, reproduced here with permission.

Then, using a six-way work status scheme similar to the previous one for Africa but different in some specifics, the Costa Rica study (Alaniz et al. 2020) reveals that the highest-earning category is the formally self-employed and the lowest-earning category is the lower-tier informally wage-employed (see Figure 4).

Figure 4: Mean earnings across six work statuses: Costa Rica



Source: reproduced from Alaniz et al. (2020), under the Creative Commons licence CC BY-NC-SA 3.0 IGO.

This fine-grained pattern would not have been found if just the aggregates in Figure 3 had been used instead.

In addition to examining which of the six work statuses pay more on average than others, we can also explore other questions at a point in time. How many workers are found in each of the six work statuses? Which personal characteristics are associated with employment in the different work statuses? Apart from cash earnings, how do the different work statuses compare in terms of non-wage benefits? As other studies for this UNU-WIDER project are completed, it will be interesting to see what answers they are able to provide at such a level of disaggregation.

3.2 Analysing comparable cross sections

Moving from single cross sections to comparable cross sections, we can learn how the cross-sectional picture is changing over time. The results of a previous study (Cruces et al. 2017) are revealing, which includes research conducted for each of the 16 Latin America countries (Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Honduras, Mexico, Panama, Paraguay, Peru, El Salvador, Uruguay, and Venezuela) along with cross-country analysis. Remarkable progress was found in all three aspects of the growth–employment–poverty nexus across the Latin American region.

Growth

All 16 countries achieved positive rates of annual growth of real GDP per capita during the 2000s, ranging from 1 per cent a year in Mexico to 5.6 per cent a year in Panama and Peru. The regional average for the 16 countries was just under 3 per cent, well above the annualized rate of growth of GDP per capita in OECD countries, which was 1.0 per cent a year.

Labour market indicators

A number of traditional labour market indicators were used including the unemployment rate, mean earnings, the occupational mix of employment, the distribution of employment by occupational position, the sectoral breakdown of employment, workers' educational attainments, and the percentage of workers registered with the national social security system. The rate of improvement in labour market indicators was exceptional. All 16 of the labour market indicators improved in Bolivia, Brazil and Peru, 15 of the 16 improved in Panama, and the majority of the labour market indicators improved in all of the other countries studied except for one (Honduras).

Poverty rates

Using the 4 and 2.5 dollars-a-day poverty lines ('poverty' and 'extreme poverty'), reduced rates of poverty and extreme poverty were found in 15 of the 16 countries. On average, extreme poverty fell by 45 per cent while poverty declined by 37 per cent. Only one Latin American country registered an increase in its rate of poverty.

In short, the 2000s have been a time of strong improvement in the growth–employment–poverty nexus in the great majority of Latin American countries. It is precisely evidence like this that leads to concluding that economic growth of the right type is indispensable to improving labour market conditions and thereby reducing poverty.

As the reader will have noticed, these results are for the traditional labour market aggregates. It would be interesting to see what else can be learned by examining changes in employment and earnings for the six work statuses analysed in this project, not for Latin America alone but for other regions as well.

3.3 Examining transitions and changes using panel data

Panel data analysis gives us a basis for making statements about labour market transitions that are not warranted when using comparable cross sections. Suppose we were to find in comparable cross sections that the number of people in wage employment in a country increased from 100,000 to 150,000. We *can* say that 50,000 more people were working in wage employment in the later year than before. However, we *cannot* and *should not* say that 50,000 of the self-employed found wage employment. The first is a statement about comparable cross sections; the second a statement about panel data changes. It may have been, for example, that over time 70,000 of the self-employed moved into wage employment and 20,000 of the wage-employed moved into self-employment, producing a net increase in wage employment of 50,000. To be able to make statements about gross flows (i.e. 70,000 moves from self-employment to wage employment, 20,000 moves from wage employment to self-employment), we must have panel data.

Such panel changes must be evaluated carefully. Personally, I have no hesitation in judging that the larger the number of positions in the upper rungs of the job ladder (in the previous example, the increase in wage employment from 100,000 to 150,000), the better. However, I would not take

a position on which is better: 50,000 moving up and no one moving down versus 70,000 moving up and 20,000 moving down; I see arguments on both sides.⁴

Disaggregation by work status can reveal a granularity that would otherwise have been missed. Recall that the World Bank study of Latin America concluded that the majority of independent workers (what in the present paper we are calling the self-employed) are working informally largely voluntarily, whereas the majority of informal salaried workers (in this paper’s terminology, informally wage-employed) appear to be working informally largely involuntarily (see Perry et al. 2007).

When we are able to make use of panel data, as many (all?) of the country studies in this UNU-WIDER project do, we can quantify transitions and non-transitions between work statuses in general and the six-way work status variables in particular. Doing this is important for its own sake in understanding the extent of fixity or mobility between these categories, hence the subtitle of Danquah et al.’s (2019) Africa study ‘Dead End or Steppingstone?’. Very recent papers by Danquah et al. (2019) and Raj et al. (2020) study transitions between the six work statuses. We will learn a great deal more from the current UNU-WIDER project country studies now in preparation.

Another reason to analyse transitions between work statuses is to help explain the observed panel data changes in labour earnings and other economic magnitudes. These changes enable us to perform what I regard as the most important kind of mobility analysis: the study of directional income movements. (Directional income movements are the increases or decreases in dollars, log-dollars, or some other measure of economic well-being.) From past research, we know that *change* in work status is an important determinant—and often the most important determinant—of the *change* in economic well-being of workers and their family.⁵

Knowing the magnitudes of transitions and non-transitions can provide insights into policy questions, to which we now turn.

3.4 Thinking about policy questions

For every problem, there is a solution that is simple, neat—and wrong.
—Variously attributed to Mark Twain, H.L. Mencken, Peter Drucker, and others.

Much of our work is policy-relevant, including the papers being prepared for the present UNU-WIDER project. However, we need to be careful: few if any ‘policy implications’ are going to jump out at us.

First, if we ruminate about the preceding quotation, what is the problem we are trying to solve? Is it informality? Unemployment? Low labour market earnings? Poverty? Something else? I will assert that the overarching problem in the developing world is poverty, and that informality is of interest, because the informally employed are the lowest earners and, therefore, the most likely to be poor.

The data described in the preceding sub-sections—on single cross sections, comparable cross sections, and panel data analysis—are indispensable in thinking about policy. It would surely be helpful to know the distributions of employment by work status, marginal percentages, earnings

⁴ For more on upward and downward movement and other mobility concepts, see Fields (2019c) as part of UNU-WIDER’s forthcoming social mobility project (see Iversen et al. 2020).

⁵ For example, see Fields et al. (2003) for a study of Indonesia, South Africa, Spain, and Venezuela.

ladders, work status transition matrices, earnings change data, tabulations and regressions involving personal characteristics, and much more.

I would also suggest an additional approach to data collection: asking working people. Look at these workers (from Fields 2012):



We can ask them questions like these:

- Have you registered your backyard auto-mechanic shop with the government so that you can receive social security benefits? Why or why not?
- How much do you earn as a bicycle rickshaw driver? What could be done to enable you to earn more in this kind of work?
- Why are you earning your livelihood making and selling Zulu shields? Could you have been working in wage employment instead?
- Are you able to move out of this work? Why or why not?

Now, let's think about policy choices. Here are two different policy syllogisms.

First:

- We want to help the poor.
- The poor work mainly on family farms and in family businesses.
- Therefore, we should invest our development resources in improving incomes where the poor are, on family farms and in family businesses.

And second:

- We want to help the poor.
- The poor will remain poor as long as they remain in poor work statuses.
- Family farms and family businesses pay poorly relative to wage employment, particularly when the wage employment is in enterprises registered with the government.
- Therefore, we should invest our development resources in creating new wage employment in registered enterprises so that the poor can move to the parts of the economy where earnings and social protections are higher.

These two arguments lead to precisely *opposite* conclusions. According to the first, the available resources should be used on family farms and family businesses.

According to the second, the available resources should be used to create new wage employment in registered enterprises so that the poor can get *out* of family farms and family businesses. (Fields 2012: 92.)

What should be done with the available resources? Use them for just the first? Just the second? Split them between the first and the second? Do something entirely different, like formalizing the informal or investing in education and skills development?

The simple answer is that *none* of these is *necessarily* the right policy choice. Policy recommendations need to be founded on a sounder basis such as social cost–benefit analysis or general equilibrium analysis. We owe it to people like those pictured to try.

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