Spotlight 1
Work in the Informal Economy

What is the informal economy?

Few of the phenomena that occupy the time of governments, economists, and others in the business of crafting and executing policy are as ambiguously defined and as difficult to measure as the "informal economy." It is inherently difficult to observe that which, by its very nature, people are trying to hide (Schneider, Buehn, and Montenegro 2010). A form of economic activity that first captured the interest of anthropologists and sociologists in the 1950s and came under the scrutiny of development economists in the early 1970s with a seminal report by the International Labour Organization (ILO), the informal economy became a central focus of policy in the late 1980s and early 1990s, when sufficient data became available to show that it was far more than cottage industry, taxi drivers, and children selling candy on street corners.

So what is the informal economy? Definitions change according to who is asking and what motivates their question. A minister of finance might ask in order to know where and how many untapped sources of additional tax revenue can be found. But a minister of labor or the leader of a trade union might ask in order to have a better idea of where to concentrate efforts to ensure that the rights and protections of labor market regulation are upheld. A minister of trade and industry or the head of the local chamber of commerce might ask in order to know where opportunities to expand sales, ensure fairer competition, and improve productivity might lie. A neighbor, frustrated by the time it takes to get his electricity service installed, might want to know who could do the job sooner, faster, and probably for less if paid cash in hand. And from each of these perspectives, a different definition can be drawn of what exactly the informal economy is.

In 2002, at the ninetieth session of the International Labor Conference, the term "informal economy" was defined as "all economic activities by workers and economic units that are not recognized, regulated, or protected by existing legal or regulatory frameworks and non-remunerative work undertaken in an income-producing enterprise."[1] Although this definition seems comprehensive, it can be unwieldy. The Organisation for Economic Co-operation and Development (OECD 2004, 2008) offered a more parsimonious definition: the informal economy is "employment or other economic activity engaged in producing legal goods and services where one or more of the legal requirements associated with employment and production are not complied with." This is a more widely applicable definition, although still challenging to measure.

In this report, we use the overarching term "informal economy" in reference to market-based production of goods and services that are, in essence, legal under prevailing laws, but concealed to avoid payment of income taxes and social insurance contributions and to escape product and factor market regulation. We count as the "informal" workforce the self-employed and employers who employ five or fewer workers, workers without a written employment contract, unpaid family workers, and those who do not make social insurance contributions. Data limitations, discussed later in this section, rarely allow measurement to be as precise as definition, however, and force us to use one observable feature or another throughout this report.

Why does it matter?

Why should policy makers be concerned about informal employment and the informal economy? People work and do business outside the confines of social, labor, and

business regulation for a variety of reasons. Some *exit* the structures of the formal economy to escape regulatory costs or to enjoy greater flexibility, while others are *excluded* by a lack of opportunities for advancement and actual barriers to better-protected, higher-productivity jobs (Perry et al. 2007; Packard, Koettl, and Montenegro 2012).

But whether they are working informally because they "exited" or are "excluded" from formal employment, widespread informal work and a large informal economy can be treated as evidence of inadequate and unsustainable social institutions: the very institutions the state puts in place to help households to build, sustain, and protect their investment in human capital as they enter the labor market to seek a return on this investment. Indeed, a large and growing informal economy can been seen as the consequence of a mass opting out of institutions by firms and individuals and "a blunt societal indictment of the quality of the state's services provision" (Perry et al. 2007).

Informal employment has long concerned policy makers for several reasons.

First, there is the problem of the individual and her family. People working informally and their dependents face explicit and implicit barriers to public and privately provided insurance instruments for managing potentially impoverishing shocks to their income. Even if people are able to manage many risks to their well-being without the help of the state, they may find it difficult to assess the costs of certain needs accurately, such as their health care or a period of job search, or to make sufficient provision for losses far in the future, such as adequate income arrangements when they can no longer work in old age. Nor do people who work informally have easy access to credit or recourse to rights and the legal protections these afford when things go wrong.

Second, there is the problem of the firm. In countries with large informal economies, bigger firms are often taxed excessively to make up for revenue lost to the government from widespread evasion. This can discourage investment and hinder growth. Furthermore, firms operating within the rules face unfair competition from those operating outside the rules. Firms that operate in the informal economy can be constrained to a small size to escape detection by the tax authorities and may have to forgo a more efficient scale of production. And like households where the main breadwinner works informally, these informal firms also have limited access to credit and recourse to legal protection when they need it.

Third, there is the problem for society as a whole. A large informal economy imposes heavy costs that deteriorate services and public goods. This is what economists like to call a "free-rider problem"; in extreme cases, it can corrode civic structures to such an extent as to contribute to government failure. As a specific example of this corrosive process, a country's social "risk pools," such as public old age, unemployment, and health insurance and the tax and transfer system, become fragmented, inefficient, and too expensive to remain viable.

What to do about the extent of informal employment and the size of the informal economy is a dilemma that has been gaining urgency. The forces that accompany globalization put a premium on mobility and skill renewal. Rapid population aging will require that people work longer and be far more productive. To achieve this, social institutions have to be more "pro-work," encouraging greater participation. As the rate of growth moderates, public financial resources will be increasingly scarce, giving urgency to measures that can significantly and sustainably increase tax revenue.

How is informal employment measured?

It is particularly challenging to measure the informal economy and informal work in East Asia Pacific economies. Microdata from household and labor force surveys are abundant and, for some countries, of excellent quality. These data can be used to identify

employers, people in self-employment, and people working in a family business without payment. We have used firm surveys to identify the demand for labor from smaller enterprises and compare this with demand from larger businesses that are more likely to be formal.[2] However, none of the surveys we have exploited for this report asks respondents the crucial questions required to identify unregulated dependent employment. In most low- and middle-income countries in Latin America and the Caribbean and in Europe and Central Asia, it has now become standard in labor force surveys to ask respondents about (1) the size of the firm in which they work (that is, the number of people employed), (2) whether they have a written labor contract, and (3) whether they make contributions to a social insurance plan (retirement pensions, health care, or unemployment insurance) or whether their employer does so on their behalf. The last two are particularly important for identifying people working informally in otherwise formal enterprises. To the best of our knowledge, in East Asia Pacific, only in Indonesia and the Philippines have the statistics authorities included these questions in their surveys and only in a one-off, special-purpose survey in the latter.

Given the limitations of available microdata from East Asia Pacific countries, we use three measures throughout this report as proxies for the extent of informal work: self-employment, "vulnerable" employment, and the share of the labor force not making contributions to social insurance. Each measure has limitations.

Not all self-employed people are working in the informal economy. Even if they are a minority, many people who report self-employment as their main form of economic activity comply with regulatory and tax requirements. While it is the proxy measure that is most observable and widely available across countries and over time, the share of the labor force in self-employment will include people who are not working informally according to any of the dimensions discussed above.

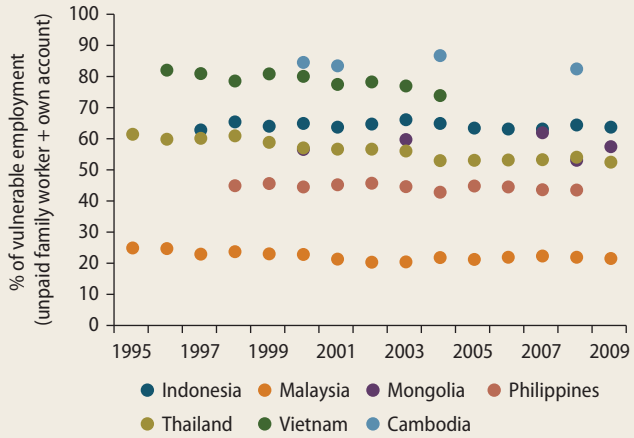
So-called "vulnerable" employment is derived simply by adding people in unpaid family work to the self-employed. Although also widely available, this variable has the added ambiguity of including people who, although not receiving wages, may be residual beneficiaries of family enterprises. If the family business prospers, in most cases it is reasonable to assume that they will prosper too.

Finally, the share of the workforce not contributing to social insurance is the inverse ratio of two aggregate statistics—the number of contributors and the economically active population. However, although it is a fairly precise measure of people working without the protection of social insurance (at least in countries where access to protection requires a history of contributions), it is not widely available.

Informal employment in East Asia Pacific

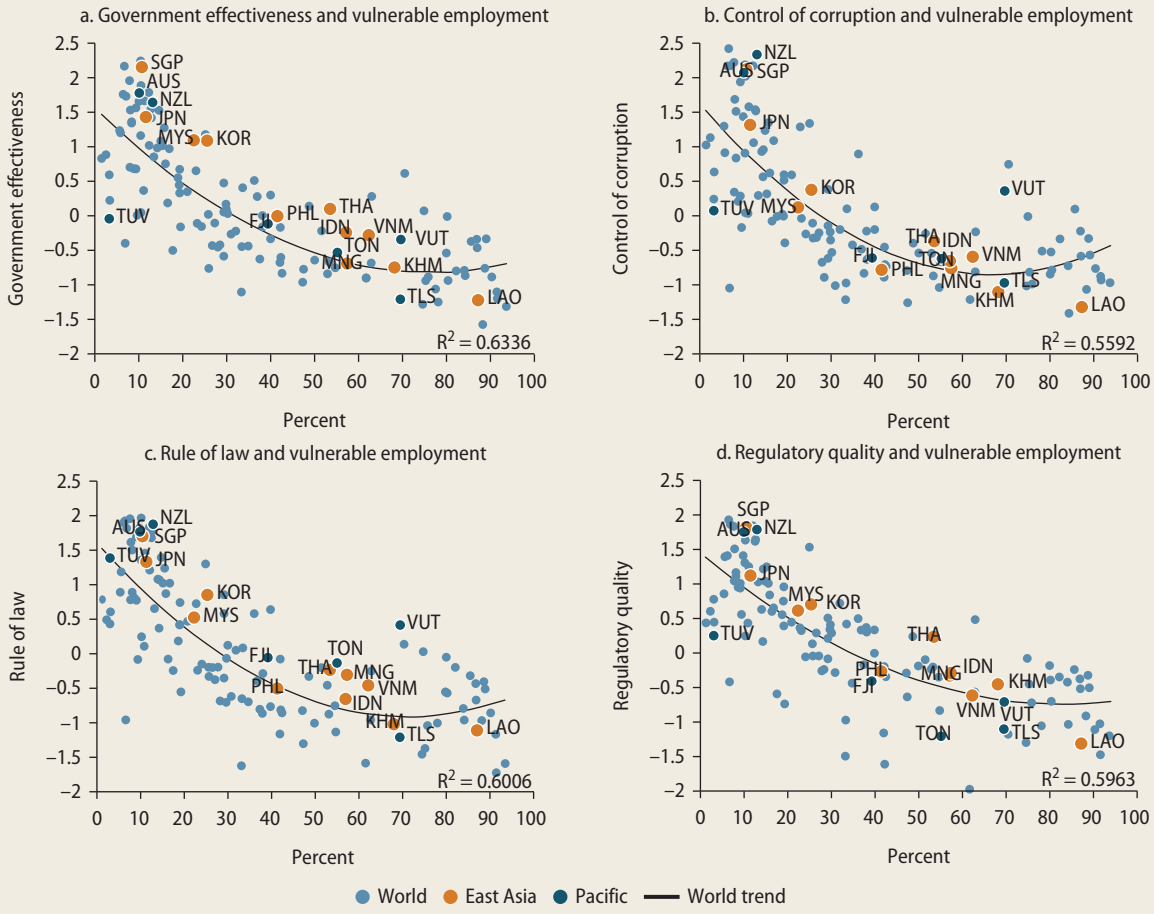
Have the economies of East Asia Pacific been creating more formal than informal work in recent years? Figure S1.1 shows

FIGURE S1.1 Vulnerable employment has remained steady in most East Asia Pacific countries



Source: World Bank 2013a.

FIGURE S1.2 Informal employment is higher where governance is weaker



Sources: Estimates based on data in World Bank 2013a, 2013b.

that the share of unpaid family and own-account workers remained fairly stable in most economies of the region during the past decade, except for Mongolia, which experienced a slight reduction. This is in sharp contrast to low- and middle-income countries in Latin America and the Caribbean and in Europe and Central Asia. However, when measured by the share of contributors to social insurance, formal work has increased in China, Mongolia, and Vietnam (chapter 7). By this same measure, there has been little change in Indonesia and the Philippines.

By most proxy measures, the low- and middle-income economies of East Asia Pacific stand out as places with extensive informal employment. Only countries in Sub-Saharan Africa tend to show consistently higher rates of informality, while those in South Asia may show higher rates by some measures. Much of informal work, however, is "structural" informality: it reflects a large portion of people still working in subsistence and small-scale commercial agriculture beyond the reach of regulation and taxation, as well as the speed of migration to towns and cities. While

there are good reasons to expect widespread informality to persist even with urbanization (Ghani and Kanbur 2013), a significant portion of the informal sector tends to disappear as countries grow in wealth.

However, in the chapters of part II we present evidence that associates the extent of informal employment with taxation and, more evidently, with labor market policies. These factors are important to take into account. But as research from Latin America and Eastern and Southern Europe shows, neither differences in taxation nor differences in regulation provide a fully satisfactory answer to the question of what drives people into informal work. What matters just as much as labor regulation and taxation is the credibility of the state as provider of services and public goods.

Figure S1.2 shows that vulnerable employment tends to be higher in countries with weaker institutions and governance. Just as policy makers have to look beyond the labor market for ways to sustain demand for employment, "formalizing" a greater share of economic activity can require measures to improve governance and the credibility of the state in the eyes of working people.

Notes

1. Informal employment, according to the ILO, includes own-account workers (self-employed without employees) and employers employed in their own informal sector enterprises; unpaid family workers, irrespective of whether they work in formal or informal sector enterprises; members of informal producers' cooperatives; own-account workers engaged in the production of goods exclusively for final use by their household; and employees holding informal jobs in formal or informal sector enterprises or working in households as paid domestic workers. For this last category, *informal jobs* are those where the employment relationship is not subject to legislation, income taxation, social protection, or entitlement to codified benefits, such as advance notice of dismissal, severance pay, paid annual leave, or sick leave.
2. We have not, however, separated firms into those registered and those not registered, which would be the best accepted practice for quantifying demand for work from businesses that operate fully in the informal economy.

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