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Informality Revisted *

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The paper develops a view of the informal sector in developing countries primarily as an unregulated micro-entrepreneurial

Introduction

Three decades of research have not yielded consensus either on the definition of the formal sector or its *raison de ser*.¹ Broadly speaking, the small-scale, semi-legal, often low productivity, frequently family-based, perhaps pre-capitalistic enterprise continues to employ between 30% and 70% of the urban work force in Latin America. A long tradition views formal workers as comprising the less-advantaged sector of a dualistic or segmented labor market.² Above market-clearing wages force workers to queue for preferred jobs while persisting in the informal sector, that is characterized by an absence of benefits, irregular work conditions, high turnover and, overall, lower rates of remuneration. A recent variant of the dualism view, albeit with different emphasis, sees informalization as an effort by firms facing international competition to reduce these legislated or union induced rigidities and high labor costs, particularly through subcontracting production out to unprotected workers.³

Recent evidence suggests that that such a view does not convincingly describe the Latin American case. This review, while looking at several countries, draws particularly heavily on my own work looking at Mexico and does not pretend to do provide an exhaustive account of the literature. Nonetheless, this particular case is an important one for several

primarily been concerned about preserving employment rather than raising remuneration, and wages have shown extraordinary downward flexibility during crises.⁵ Second, Mexico is blessed with excellent panel employment surveys that allow following workers among sectors over time and observing how their earnings may change. The view that emerges from these data, time series data from other Latin American countries, and global cross sectional data correspond more to an unregulated entrepreneurial sector that behaves like small firm sector everywhere, than one comprised of involuntary, disadvantaged, precarious, or underpaid workers.

the core of the informal sector- the self-employed

Self-employment in Mexico constitutes the largest source of employment among men (55%), after formal salaried employment (50%). Table 1 shows that, of those workers who started in the formal salaried sector but move into informal self-employed sector 15 months later,⁶ two-thirds report moving voluntarily, citing a desire for greater independence or higher wages as the principal motives. These findings are consistent with the sociologists Balár

self-employed had no desire to change jobs and under 18% saw self-employment as a temporary activity before they found a “real” job.⁸ In Gran Buenos Aires, another survey found that while 36% would have preferred to work more hours, only 26% were looking for other work.⁹ In Paraguay, only 28% of those in the informal sector stated a desire to change occupations. Among those often thought to be the worst off, informal workers, the percentage rose only to 32%.¹⁰

Panel data from the Mexican National Urban Employment Survey (ENEU) show that, in industrialized countries, self-employment is not an entry occupation from school and there is little evidence that the sector serves as a holding pattern for young workers. Transitions to self-employment from the other paid sectors occur 4 to 6 years later than transitions into formal or informal salaried work leaving the mean age 8 years higher than the next closest sector.¹¹ This is supportive of the findings of Balán et. al., and increasingly elsewhere, for a “life cycle” model where workers enter into salaried work, accumulate knowledge, capital, and contacts, and then quit to open their own informal businesses.¹²

The Guadalajara sociologist Gonzalez de la Rocha (1994) is almost certainly correct that for many older workers, the sector does provide a safety net by offering “insecure

she does also, however, suggest some degree of voluntary movement when she says that older men may also find the pace of industrial (formal) work too arduous and leave such jobs.”¹³ This more voluntary take is stressed by her anthropologist colleagues Selby, Murphy and Lorenzen (1991) who note the “surprising desirability of informal sector employment as a basis for a household earning strategy, particularly for poorer, older household with low educational qualifications.”¹⁴

On balance, sociological and anthropological studies are consistent with the findings of the Mexican, Argentine and Paraguayan micro-enterprise surveys that most self-employed choose to be so, as well as the view that workers may enter formal sector employment initially as a means to accumulate human and physical capital. This leads to an intriguing version of the traditional dualist view. If firms must pay “efficiency” or above market earning wages to dissuade their workers from opening their own firms, this creates a segmented market. It may be the attractiveness of informal self-employment that causes dualism rather than a segmented market causing informality.¹⁵

But don't informal workers earn less?

Several examples may make this clearer. First, if the formal sector pays benefits such as pensions, health insurance, housing subsidies, day care -- which the informal sector does not receive, then in a market with no distortions, the wage in the unprotected sector would need to be higher than in the formal sector to compensate for the lost benefits. This higher wage, of course, would not imply a superior job -- only that more of the total remuneration was paid in cash rather than in benefits. On the other hand, income taxes support public goods from which tax evasion by informal workers can not be excluded (national defense for example), and therefore the government would state that formal sector workers need to be paid more to compensate for the taxes they can avoid. Further, formal work-places may be cleaner and safer, but, as in the industrialized world and as table 1 suggests, being one's own boss and having flexibility is very valuable and is worth taking a wage cut for. Finally, starting a business is risky anywhere and we would expect to find higher incomes among this group to compensate them for this risk.

Though informal salaried workers always earn consistently less, this may be due to the fact that they are often related to the owners of the enterprises where they work and thus may receive unobserved payments in kind (food, lodging). Further, to the degree that the sector appears to play a job training role for young workers, some fraction of the salary may be

The traditional “dualistic” view would argue that as the economy enters a recession one should find workers being forced into the informal sector, driving down wages there relative to the formal sector wage. This does seem to be the case in Colombia after 1995, a period of deep recession due to a financial crisis combined with a very ill-advised but very dramatic rise in the minimum wage that accentuated the segmentation in the economy. Figure 1 shows that the relative size of the formal sector relative to the informal self-employed sector fell while its relative wage rose—exactly the pattern predicted by the dualistic view. But figure 2 suggests that the 1987-93 period was very different in Mexico. Here the share of the workforce in self-employment grew at the same time that the self-employed went from earning roughly the same amount as formal salaried workers, to 30% more by 1992. The boom in construction and other non-tradeables offered many good jobs to informal skilled workers and this is when they choose to open their businesses.¹⁶ This pattern reverses somewhat going into the crisis of 1995 where there is an increase in the size of the self-employed sector at the same time that relative self-employed earnings are falling. But, the point here is not to show that the informal sector *never* serves as a safety net. Rather, the point is that most c

formality is rising across the period. But the critical question is whether it was voluntary!

Another counterintuitive finding appears in table 2. Here we use panel data from Mexico and Argentina to ask the unemployed what sector they entered from. Surprisingly 5% of the unemployed in Mexico and 64% in Argentina were informal previously. Although their unemployment spells are 30% lower than those of formal sector workers, it is not the case that they instantly find new informal jobs. So the sector is not simply or even primarily absorbing the unemployed from the formal sector. As we'll see later, there is a logical reason why this may be the case.

But why would workers voluntarily give up these formal sector benefits?

There are several reasons why workers may be willing to voluntarily become "unprotected" and rely more on informal safety nets. First, developing country microentrepreneurs may not be fundamentally different from their counterparts in the industrialized world who also take on responsibility for medical insurance or saving for retirement that was previously covered by their employers. Second, since in a market with flexible wages, the

These last two issues suggest that, in contrast to the usual view, the extant labor protection may make formal sector work less desirable, rather than less attainable.

Doesn't the large size of the informal sector imply large labor market distortions ?

The argument that informal employment can be desirable is most compelling where micro-firms can offer remuneration comparable to that earned in the formal sector- among low education workers unlikely to generate much firm specific capital. Observing Mexican formal workers, the anthropologists Selby, Murphy and Lorenzen confirm that “On average the opportunity costs to these workers in terms of foregone earnings in, say, registered blue collar employment may be quite low.”(p. 147) This view is supported statistically by logit analysis of Argentine and Mexican worker movements between sectors that finds that they become less likely to leave formal employment for self-employment, or any other informal sector, as their education level increases. At a global level, figure 4 suggests that as formal sector productivity increases with development, the share of the workforce in self-employment falls. When we control for productivity (or GDP) and other relevant demographic variables, Latin America does not have an unusually large share of its workforce in informal self-employment: Mexico and Brazil are below average. Perhaps suggesting more flexible labor

n't informal work precarious?

Many of the characteristics we associate with informality are, in fact, natural byproducts of the fact that the informal *cuenta-propista* or patron is fundamentally a micro-entrepreneur--the owner of a small firm. The industrialized country literature on firm behavior offers two important findings about such firms. First, there is a wide range of sizes among standing firms determined by such factors as how efficient or hardworking an entrepreneur is, how well-placed his/her firm is, what the logic of the production process is, etc. This means that the existence of many small firms does not necessarily imply failure of either labor or credit markets. It may be that the reason that 80% of micro-firms have only or two employees and tend to be family based reflects a logic that has roots in the tradition of the family farm, or reflects the sustainable reach of informal contracting relations. This could explain, for instance the finding that only 10% of urban Mexican micro-firms report plans for expansion and only 9% report that lack of credit is a major business problem.¹⁸

A second finding about small firms everywhere is their extraordinarily high rates of failure. Seeking to explain the US case, the economic theorist Jovanovic (1982) argues that this is due to the fact that entrepreneurs cannot know how good their location is, or how good an entrepreneur they are until they actually start the business. Very soon after starting, many find that they are not viable and fail. The sociology literature provides striking confirmation of this insight when Ballal, Browning and Jelin argue that although self-employment is a goal for many Mexican workers:

Becoming self-employed involves a large risk, especially for those men who had stable and secure jobs. Income is uncertain, in particular during the first perilous years of the business. Often the men lack the financial and administrative skills needed for successful operation of the enterprise. Most men are aware of the fact that many small shops and stores close soon after opening. Some men therefore proceed with much care when they decide to become self-employed. (p 216-217).

That said, rough calculations from the Mexican micro-enterprise survey suggest that these firms, show high failure rates, but not particularly higher than those in the US.

If we add a new view of “formality” to this picture, we can generate most of the

mechanisms, pool risk, gain access to credit-- all things that become increasingly important as firms grow. De Soto (1989) offers a striking example where informal street vendors in Peru tried not to avoid, but to pay their taxes since this would guarantee them some property rights over their pitch and hence offer some security to investments they wanted to make. Statistically, the data from the Mexican micro-enterprise survey suggests that firms do become more formal with age and size.¹⁹

Combining the two characteristics of micro-firms and our notion of formality implies that small firms will have higher costs, are likely to be informal, and will have very high failure rates. Though this corresponds exactly to the standard picture of the stagnant, precarious, unprotected informal worker familiar in the literature, it is, in fact, the opposite. It emerges naturally from the workers trying their luck at entrepreneurship (risk taking), often failing, and not engaging in the formal institutions until they grow. In sum, there may be nothing pathological about the informal sector firm and its existence may be largely unrelated to questions of labor market dualism or even credit market distortions.

But this also may explain the high rates of entry into unemployment found in table 2. Small firms have high mortality rates, both owners and the workers are more likely to find

come streams.²⁰ In sum, for workers desiring to become self-employed, there are informal strategies for managing risk.

Doesn't the informal sector show lower overall productivity growth?

This is very likely to be the case, but not because of informality per se. Traditionally the big gains in productivity occur in the tradeables sectors and often (although not exclusively) in manufactures. This differential in productivity growth underlies Balassa' (1964) theory of why the real exchange rate appreciates as countries develop.²¹ Informal businesses tend to be concentrated in services, transport, commerce in the like where productivity gains are hard to achieve: A haircut still takes about 20 minutes in Washington or Bogotá. But this doesn't mean that wages of informal barbers won't rise over time. As productivity rises in the formal tradeables sector, workers are slowly pulled from the informal sector, and wages must rise there to keep barbers from moving in to formal manufacturing.

Since only 20% of Mexican informal workers are found to be affiliated with larger firms, early sub-contracting relations are not the dominant modality of informal firm behavior. Furthermore, it appears that the path of earnings across time of those who worked in sub-contracting relations followed very closely those who were independent. This suggests that common motivations may underlie a worker's decision to engage in sub-contracting, and that the sector may not represent inferior work. This is supported by the sociologist Bryant Roberts' (1989) interviews with Guadalajara workers that suggest that, given the very weak institutions and low wages in Mexico, informalization is not primarily a strategy for reducing remuneration and worker control over production: "Market uncertainty and the large number of income opportunities in the city mean that it is useful for *both* employees and employers to have flexibility in allocating labor." (italics added, p. 48). More generally, it is possible that sub-contracting is not so much a way of avoiding labor legislation, as avoiding the inefficiencies in it. The differentials between costs to firms and value to workers of benefits discussed previously offer a benign interpretation of informal subcontracting as a way of reducing firm costs where contract workers gain some of the value of benefits foregone.

formal jobs of any group, male or female, makes discrimination seem unlikely. This does not, of course, preclude discrimination against married women or those with children who may be likely to be absent for work for long periods. But Cunningham argues that the concentration of these two groups in self-employment driven by the need to balance household responsibilities. For women attempting to raise children as well as contribute to household income, the flexibility of the sector may make the sector even more desirable than for the men discussed earlier.

ren't the informal salaried the most disadvantaged?

Even if the self-employed benefit from being their own bosses, the mainstream view is that those who work for them are the very worst off of the urban workforce: salaried, yet without benefits. We've already discussed how the fact that they appear to earn lower wages tells us nothing about whether they are truly worse off. Further, rather than being a stagnant group of disadvantaged workers, the sector appears to serve primarily as the principal though not exclusive, port of entry for young, poorly educated workers into paid

is only 1.4 years and 25 to 34, 3.4 years.²² Further, if Hemmer and Mannel (1989) are correct that in many countries informal small enterprises train more apprentices and workers than the formal education system and the mostly government job-training schemes together, these years to a large degree may constitute continued schooling. Even if this pattern of transition from school to unpaid to informal salaried work to other modes of work represents queuing that the dualistic literature might predict, the wait in informal salaried work is not long.

The sector appears precarious for two reasons. First, Ball et al. argue that this period of life for young workers is one of “shopping around” and trying out various possible choices, and hence they will show short tenure. Second, the vast majority of informal salaried workers are employed by informal micro-firms which, as discussed earlier, have high turnover rates.

II. Conclusions

The view of the informal sector sketched here is not meant to suggest that in periods of great recession or in countries with very distortionary minimum wages and regulation th

ve argued, for example, that informality may arise partially as a response to inefficiencies in the provision of medical benefits or pensions, promotion systems not based on merit, or other distortions that make being paid in cash informally more desirable. The recent reforms in Chile, Colombia and Mexico that have sought to bring benefits in line with the implicit taxes that workers pay, for instance individual accounts for retirement pay, are important steps to reducing incentives to being informal. More fundamentally, informal employment in firms with relatively low technology and capital intensity can only be attractive if the overall level of labor productivity in the formal sector is low also. To the degree that current legislation impedes investment in physical or human capital, or prevents the efficient organization and operation of firms, it perpetuates the low levels of productivity throughout the economy.

Finally, I do not mean to suggest that the sector is not relatively poor. However, that poverty is a function of low levels of human capital and whether the worker is formal or informal is largely incidental. A worker with few skills that would be rewarded in the formal sector may prefer to be independent: S/he may prefer being the master of a lowly repair shop to endlessly repeating assembly tasks in a formal maquila. Neither job will lead to an exit from poverty, but the informal option may actually offer a measure of dignity and autonomy that

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Table 1: Real Hourly Wage Differential: Formal Salaried to Informal Self Employee
 In percentage change)

	<i>Share of Respondents</i>	<i>Mean Differential 3/</i>	<i>Median Differential</i>
<i>National Urban Employ. Survey (ENEU)1/</i>	100	27.3***	23.6***
<i>Micro-enterprise Survey (ENAMIN): 2/</i>			
<i>Reason Left Previous Job</i>			
More Independence	35	21.6**	19.6*
Higher Pay	32	16.7	12.1
Involuntary	29	-14.7	-4.1
Total	100	12.6**	10.0**

1/ Adjusted for hours worked and taxes. 2/ Adjusted for hours worked, taxes, capital costs, unpaid workers. 3/ Mean employs Huber weights to redress non-normality. * = sig. at 10%, ** 5%, ***1% level.

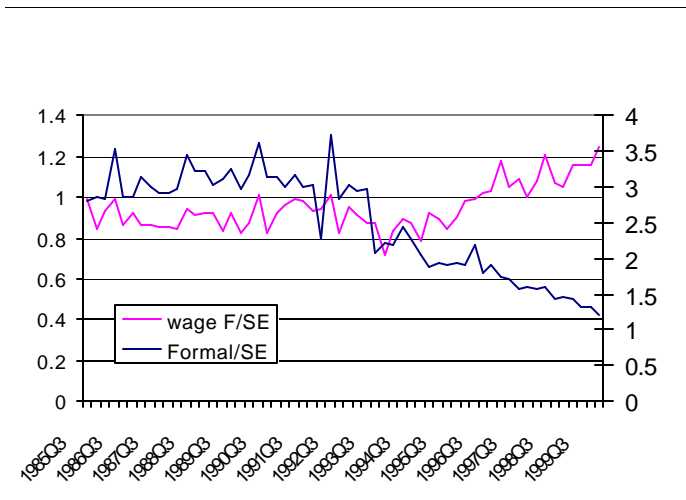


Figure 1: Colombia, Relative Sector Size and Earnings



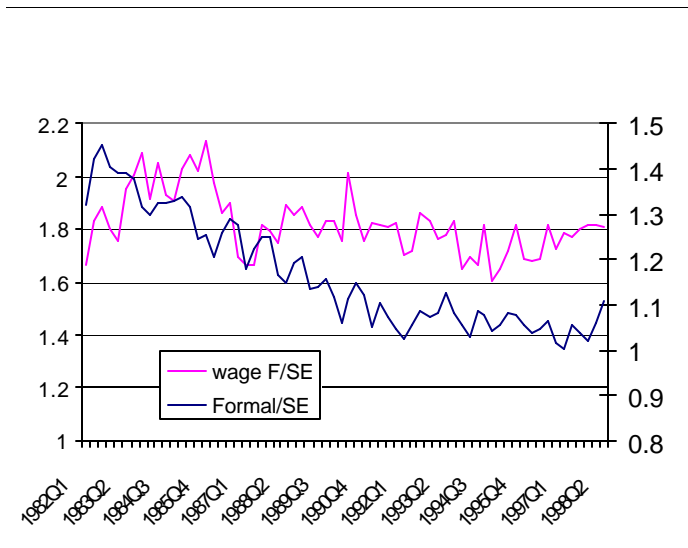


Figure 3: Brazil, Relative Sector Size and Earnings

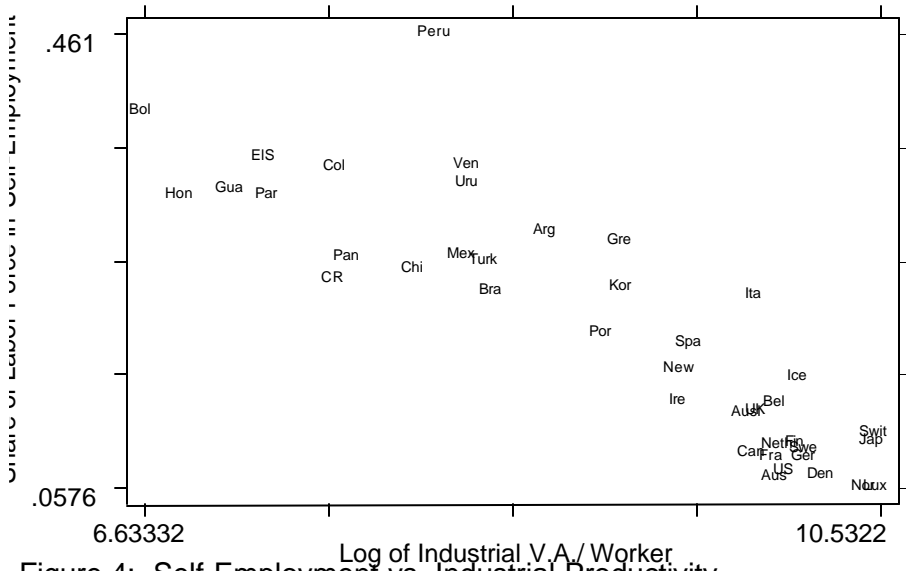


Figure 4: Self-Employment vs. Industrial Productivity