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1

Introduction: Informal Labour Markets and Development

Basudeb Guha-Khasnobis and Ravi Kanbur

The majority of the poor in developing countries depend on the informal sector for their livelihoods. Understanding the informal sector – in particular, informal employment – is therefore crucial for the success of economic development and poverty reduction strategies. Its persistence and expansion over time and across countries prove that the informal sector is not a transitory phenomenon in the development process, waiting to be absorbed by the formal sector. Rather, it is now fairly well recognized that formal and informal sectors will cohabit, and are very much interlinked in subtle and complicated ways. This volume introduces a significant new collection of papers on informal labour markets in developing countries. The papers were originally presented at a major conference organized in Helsinki by the Expert Group on Development Issues (EGDI) at the Swedish Ministry of Foreign Affairs, and the World Institute for Development Economics Research (UNU-WIDER) in September 2004. We have divided the volume into two parts. Part I, *Economic Reform and Informal Labour Markets*, addresses the new dimension added to the complexity of informal labour markets by the recent waves of economic reforms in many developing countries. As the urban informal labour market has been the subject of special policy concern, Part II, *Survival Strategies of the Urban Poor*, focuses on informal employment in the main cities of selected developing countries.

In most cases, certain operational criteria, such as lack of social security coverage, leave entitlements and written contracts, are used to define informal employment. Common additional characteristics include a low level of earnings, unstable working conditions, lack of affiliation to labour organizations and the illegal or quasi-legal nature of the work performed. These common operational criteria were used to identify informal employment in the different chapters of this volume.

In Part I, we attempt to explore the transforming relationship between the formal and informal sectors during liberalization as well as transition. Informal wages are the relevant earning index of the substantial majority of the workforce in a developing economy. Marjit and Maiti (Chapter 2) establish in theory that the impact of deregulatory policies on this index will be positive, provided capital is allowed to flow into the informal sector. They also find empirical support for this proposition after analyzing survey-based data on India during its phase of liberalization. As export markets expanded in India, the informal rural industries showed increasing dynamics of technology adoption and growth, leading to a reorganization of the informal–formal relationship in production. It was difficult for smaller units to survive independently. Rather, it was profitable for them to tie up with larger units with better access to capital and information regarding markets and policies. Marjit and Maiti observe that an increasing amount of working capital went to this newly emerging class of *tied* artisans and, simultaneously, there was a decline in capital formation in the formal sector. Thus, far from absorbing informal activities, the formal sector actually relied upon the informal sector in order to increase its competitiveness and profits.

Unsurprisingly, therefore, high and sustained growth rates are not necessarily accompanied by a corresponding growth in formal employment. Sinha and Adam (Chapter 3) explain this apparent phenomenon of ‘job-less growth’ in India with the help of a Computable General Equilibrium model. Their simulations imply that official statistics may correctly record the number of ‘registered’ workers declining, but they fail to record the strong growth of ‘unregistered’ workers in the economy. Growth in the economy is actually supported by a huge force of ‘unregistered’ or informal workers. Sinha and Adam vindicate the findings of Marjit and Maiti while concluding that, in the face of strong competition, the formal sector of India reacted by outsourcing to the informal sector and retrenching formal workers to replace them with informal workers. However, though there is less unemployment than actually shown in official records, most of the informal workers suffer from substandard living conditions, as reflected by the fall in their real wages in the simulations. Therefore, even though the informal sector facilitates successful adjustment during globalization and, hence, should be allowed to function in its own way, there is reason to argue that certain elements of formality should probably be introduced into these markets to prevent any exploitation implied by falling real wages, at least for some of the workers.

Union-mandated formal wage contracts tend to protect workers from such exploitation by ensuring that they receive fair pay. However,

Dasgupta and Marjit (Chapter 4) show that if the state is forced (for political reasons) to maintain industrial employment despite import liberalization (for example, through cheaper credit to firms), evasion of formal contracts by employers will increase due to a rise in the formal–informal wage gap. This outcome is generated by institutional delays in the punishment of employers' evasion of formal contracts. Greater contract evasion will entail greater diversion of resources to conflict resolution between employers and unions. To moderate such waste, the state must attenuate its role as the enforcer of contracts between unions and employers.

The role of the state also comes to the fore in the case of the township and village enterprises (TVEs) in China. TVEs can be considered as an informal sector because they are mostly composed of marginal activities and remain largely unregulated. One particular aspect of TVE development is its role in job creation. Wan and Zhu (Chapter 5) estimated labour absorption elasticities for east, central and west China, as well as for China as a whole. They found that the labour absorption capacity of TVEs is quite large, with the elasticity averaging 1.6. That is, every 1 per cent increase in output could induce a 1.6 per cent increase in employment. Using this estimate, the growth rate of over 10 per cent in recent years could have produced a 16 per cent increase in TVE employment every year. That means a doubling of the labour force in TVEs every five years. This did not happen in reality because TVEs in China are becoming more and more capital intensive. In order to reap the full benefit of the labour absorption capacity of the informal sector, this point should be borne in mind by policymakers when making decisions about TVE-related government policies.

The relative expansion of the informal sector is also a hallmark of countries in transition. Dimova, Gang and Landon-Lane (Chapter 6) report that in Bulgaria, the private sector is composed of two very different groups of labourers; those who obtain formal private sector jobs and those who obtain informal private sector jobs. The cause of the co-existence of the formal and informal sectors appears to be the side effects of deliberate government policy. Government policy *vis-à-vis* extra taxes, protective labour legislation, support for unions, payoffs, and a variety of other measures ensures, 'artificially', that the formal private sector will be a high cost sector. The political economy of transition led to policy inertia during the first half of the 1990s. A banking crisis struck in the period December 1996–January 1997. Rapid privatization of state-owned enterprises followed. Between 1995 and 1997, the informal sector grew both absolutely and relatively to the private sector, while the public sector

shrank in absolute and relative terms. Overall, the pattern of the transition is one of movement out of formal employment into informal employment. The crisis caused a large reduction in the size of the public sector, and displaced workers could not find jobs in the formal private sector. Hence, they were forced to find work in the informal private sector. Also, the economic crisis forced people who were initially out of the labour force to rejoin the labour force, mostly in the informal sector.

The informal sector thrives mainly in the proximity of its formal counterpart and, hence, it is largely an urban phenomenon. In Part II, Azevedo (Chapter 7) presents empirical evidence on the determinants of labour market earnings for males and females in the slums of Rio de Janeiro, using data from a survey of 21,704 households spread over 51 slums. A main finding is the substantially lower returns to education for the residents of the slums of Rio de Janeiro when compared with the existing empirical evidence from other developing countries. There are significant neighbourhood effects in the city of Rio de Janeiro – the workers from slums closer to more affluent areas of the city had greater earnings, particularly in the case of males.

There is a substantial earning differential between formal entrepreneurs and formal wage-earners, as well as informal entrepreneurs and informal wage-earners. Entrepreneurs (both formal and informal) form the only occupational category in which the probability of entering increases with age, suggesting that this is an important segment for the older population (those above 40 years of age). Formal education has a positive effect on the probability of becoming a formal wage earner, playing a minor role in entrepreneurial choice, and informal wage earnings.

Mitra (Chapter 8) highlights the role of networks in accessing jobs in the urban labour market. Based on a survey of around 800 households in selected slums of Delhi, three types of network are identified. These operate through kinship bonds, caste and ethnicity bonds, and formal channels such as NGOs and employment exchanges. Variations in networks are noted across occupations. Given the differences in the nature of economic activities performed in different parts of the city, factors such as networks and the urge to reside near the contact person and the workplace make the urban labour market highly segmented. Hence, certain pockets within the city tend to become crowded by the growth of slums. Also, interspatial variations in terms of activities/occupations make slum population in the city a heterogeneous set, and thus their problems and needs vary substantially from one location to another, even within the city. Therefore, any uniform policy for clusters located in different zones may not be able effectively to tackle the problems of slum

dwellers in the city. Government measures need to recognize these informal mechanisms, which low-income households have developed over the years to cope with uncertainties pertaining to jobs, housing, expenditure and other requirements of life, so that they become complementary to each other. Though possibilities of graduation from the informal to the formal sector are quite limited, as evident from our analysis, within the informal sector, workers are able to experience upward occupational mobility through their own initiatives and willingness to help each other. Planners, therefore, must understand the role of social capital in the context of economic gains and mobility of the informal sector workers and the poor.

It is important for policymakers to ascertain whether pro-poor growth policies have to address the informal sector specifically and in any particular way, or whether the informal sector evolves as does the rest of the economy and therefore good growth policies are also good informal sector policies. Grimm and Gunther (Chapter 9) argue that linkages between the formal and informal sector can exist on a macro- as well as on a micro-level, and analyze both levels for urban areas in Burkina Faso. In this country, macro- or inter-household linkages between the formal and informal economy are somewhat weak, and it is the performance of the whole economy in general that matters most for the informal sector. In contrast, micro- or intra-household linkages between informal and formal labour earnings seem more important, and an understanding of them appears extremely useful when thinking about poverty-reduction strategies. However, this study has also shown that the linkage coefficient for both inter- as well as intra-household linkages is less than one and, hence, good formal growth policies may not be enough for sufficient informal sectoral growth. Also, according to the findings, formal sector growth policies will be more beneficial for workers in the informal sector who are linked to the formal sector via intra-household linkages, and less beneficial to workers in the informal sector who are only linked to the formal sector via the market. As a result, pure 'informal' households might be left out of the overall economic growth. Thus, for poverty analysis, it may be more useful to think in terms of a dichotomy of 'formal and informal' households than of informal and formal wage-earners.

The informal labour market is not synonymous with an unskilled labour market. Olofin and Folawewo (Chapter 10) examine the nature of skill requirements in the urban informal sector of south-western Nigeria. The importance of education, tenure and experience variables in the empirical exercise of earnings determination shows that a high level of skill is critical in the informal sector. From a policy point of view, this is

an indication that skill requirements in the informal sector, in respect of wage employment, may not be different from what obtains in the formal sector. At the same time, however, the informal labour market also propagates a social malaise; child labour. Tambunan (Chapter 11), in his survey of poor households in Jakarta, notes how these families turn to the child labour market to cope with poverty. The lack of rural development drives people to the city of Jakarta. Without inadequate infrastructure, the city wilts under the pressure of such influx, leading to fast deterioration in the living conditions of the poor, aggravating their poverty, and forcing them to send their children to work.

In Mexico approximately four million individuals originally in *extreme* poverty registered real income gains during 2000–02 and entered into *moderate* poverty, which is mostly concentrated in urban areas. Sojo and Villarreal (Chapter 12) argue that the social and demographic characteristics, as well as the economic needs of the moderate poor differ markedly from individuals in deeper levels of poverty. The moderate poor are somewhat forced to depend on informal occupation, due to certain structural factors that impede their participation in the formal sector. Opening up the formal sector for the moderate poor requires updating certain laws and regulations, and the provision of education, training, financial services, technical and administrative assistance for entrepreneurs and so on. The combination of all these policy changes should lead to improving income and social protection for the moderate poor, and integrating sectors that can benefit from trading with each other in order to increase competitiveness of the Mexican economy as a whole.

A key policy question is whether informal labour markets should be formalized. The experience gathered from this volume suggests that it is quite impossible to answer it with a *yes* or a *no*. There are several positives associated with informal labour markets: (a) they play a crucial role in developing and transitional countries in facilitating successful adjustment to the forces of globalization and reforms; (b) they provide means for survival to the vast majority of poor and very poor workers in a society; and (c) they facilitate the unlocking of entrepreneurial potential which could become lost in the mesh of formality. At the same time, there are concerns: (a) informal workers are vulnerable to certain forms of exploitation; and (b) being largely an urban phenomenon, the growth of informal labour markets exacerbates problems associated with slums, congestion, urban health and environment. Policy should aim at balancing these pros and cons, and identify the areas where formal intervention is required and to what degree.

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