



Work and Well-Being: Informal employment re-visited

by

Johannes Jütting, Jante Parlevliet and Theodora Xenogianiⁱ

OECD Development Centre

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ⁱ Author for correspondence.
OECD Development Centre
Theodora.xenogiani@oecd.org

1) INTRODUCTION

Work and well-being are two issues increasingly accepted as being at the core of the study and practice of economic development. Studies on “pro-poor-growth” clearly show that work, jobs and employment are key in transforming economic growth in actual poverty reduction (EC 2007, Lundstrom & Ronnas 2006, Osmani 2005). Equally, the concept of well-being is receiving increasing attention as means to measure the progress of societies (OECD 2001, Boarini et al 2006). Challenging the traditional income-based view on development, such well-being measures aim to go beyond income by capturing non-monetary factors that matter in life, including both objective indicators and subjective life experiences¹. Even in poor countries, where income is still arguably of greater importance relative to non-monetary factors, women and men do not define themselves solely by how much income they dispose of or how poor they are (e.g. McGillivray & Shorrocks 2007, Gough & McGregor, forthcoming). As people elsewhere, they also value self-esteem, security, access to social networks, autonomy and happiness².

Informal employment is a key issue bridging the two agendas of work and well-being. First, an enormous share of employment in developing countries is informal and informality is on the rise in most countries around the world. Second well-being considerations may go some way in explaining why some individuals prefer working informally over a job in the formal sector. There is increasing evidence that tax evasion is not the only reason for which people might choose informal employment and that non monetary aspects of work also matter. At the same time informal employment also determines well being. These observations as well as the debate on the impact of informality on the economy and the resulting policy consequences call for a more comprehensive and holistic approach than has often been applied in the past. In this endeavour it is critical to better understand individual choices, for which type of employment people opt and why. By looking beyond income factors this study tries to detect the main drivers of informal employment. This knowledge is essential for informed policy making striving for more inclusive and efficient labour markets in developing countries.

¹ There is no single accepted of well-being, but there is wide consensus that well-being is an umbrella concept including both objective measures found important for one’s quality of life (e.g. income, health, security, freedom etc.) and subjective measures capturing an individual’s experience of life (subjective well-being, happiness, life satisfaction etc. For discussions see Boarini et al. 2006, OECD 2001, Gasper 2004, Galloway 2006.

² Based on the observed positive correlation between levels of income and subjective-well being (Inglehart 2000), it can be claimed that for low levels of income, a well-being perspective is redundant as well-being and income go hand in hand. However, this correlation doesn’t necessarily imply that rising incomes alone will automatically raise well-being, as methodological and data measurement problems make it extremely difficult to come to any conclusive conclusions about causalities over time and across countries.

Against the presented background, the objective of this paper is to critically evaluate the literature on informal employment through a well-being lens with the aim to lay out a research and policy agenda for the coming years. The structure of this paper is as follows. Section 2 discusses some “puzzling” facts related to informal employment that do not seem to be in line with conventional labour market analysis. In particular, informal employment has been on the rise, heterogeneous working patterns and conditions have remained, if not increased, and there is an increasing recognition that sometimes people after weighing costs and benefits of formal and informal employment, prefer to stay informal. Building on this, section 3 critically evaluates some existing explanations of informal employment. Additionally, it suggests a more comprehensive analytical framework putting emphasis on the various determinants that influence an individual’s decision to engage in formal or informal employment. Finally, the concluding section 4 highlights some important areas for future research.

2) PUZZLING FACTS ON INFORMAL LABOUR MARKETS

In this section we will present some puzzling evidence on informal employment, which will serve as a basis for our discussion in section 3. As the data on informal labour markets need to be handled with caution, before highlighting some of the puzzling evidence, we will first briefly consider some definitional and measurement issues.

2.1. What is informality

In this paper we will not look in depth at issues of terminology³, but will provide a short review of what definitions do exist, how the concept of informality is mostly used in practice, and some issues to keep in mind when reading informal employment statistics.

2.1.1. The ILO definition

The International Labour Office is the main international body providing official definitions of the informal sector and informal employment. The first standardised definition was agreed upon in 1993, where informal work was explained in terms of the production units, i.e. informality in this sense refers to the fact of whether a firm is formal or not. Then, employment in the informal sector refers to: *“all jobs in informal sector enterprises or all persons who, during a given reference period, were employed in at least one informal sector enterprise, irrespective of their status in employment and whether it was their main or a secondary job.”* For enterprises to be informal they must be owned by individuals or households that are non separate legal entities independent of their owners; they produce at least some goods/services for sale/barter; they must be of a size below a certain threshold and engaged in non-agricultural activities. This also includes self-employment (ILO 2002b).

Still, this definition was found to leave out important segments of informal workers, and in 2003 the ILO decided also to include informal employment outside of informal enterprises. In this broader understanding, informal employment is defined as the *“total number of informal jobs, whether carried out in formal sector enterprises, informal sector enterprises, or households”*. Informal jobs refer to those jobs outside the regulatory framework because they are not subject to labour legislation, social protection, taxes or employment benefits. On the basis of this definition, several types of workers are identified: own-account workers and employers of informal firms, contributing family workers, informal employees (of formal and informal firms), and members of informal producers' cooperatives (Hussmans 2004).

³ For a discussion of the terminology of informal employment see ILO 2002a, 2002b; Hussmans 2004; Garparini and Tornarolli 2007; Perry et al. 2007 (chapter 1).

2.1.2. Definitions used in practice

The ILO definitions are not extensively used in the broader literature, as they are still quite complex and often data do not cover the dimensions needed to categorise informal enterprises and informal jobs. Instead, more one-dimensional definitions of informality are used, i.e. on the basis of a single variable. The variables chosen, however, vary a lot. Informality seems to mean different things to different people, be it for pragmatic reasons (data limitations) or more intrinsic purposes. As an illustration, see Table 1 below, which lists the indicators used to refer to informality in some recent studies, as well the advantages and disadvantages associated with the definition and measurement used.

Table 1: Informal employment –a summary of indicators used

<i>Study</i>	<i>Indicator</i>	<i>Advantages</i>	<i>Disadvantages</i>
Loayza and Rigolini 2006	"share of self-employed in the labor force (as reported in the surveys collected by the ILO)"	Self-employment in many countries captures most part of informal activity as "most self-employed workers tend to be low-skilled, unregistered workers"	No distinction between the self employed and informal wage workers
Amuedo-Dorantes 2004	Lack of a work contract	Convenience related to availability of data	Not all workers with contract are necessarily informal. This definition is also vague about the self employed
Bosch and Maloney 2006	Informal wage workers ("a lack of contributions by the employer to the social security agency") + informal self-employment ("those self employed and owners of micro firms (less than 6 employees) with no social security contributions, excluding professionals and technicians")	Comprehensive as it incorporates both self- and wage employment.	Not always practically feasible.
Packard 2007	An "informal sector" consisting of non-contract wage employment, and self-employment	Comprehensive as it incorporates both self- and wage employment; Convenience related to availability of data	Self-employment not necessarily informal.
Henley et al. 2006	(1) No signed labour card (2) No social security contribution and (3) Employment in firm with 5 or less employees	Can provide evidence on the use of three different indicators of informal employment	
Gasparini and Tornarolli 2007	(1) Belonging "to any of the following categories: (i) unskilled self-employed, (ii) salaried worker in a small private firm, (iii) zero-income worker. (2) No right to a pension linked to employment when retired.	Combine the productive definition of informal employment with that based on entitlements.	There is an important difference between belong to "any of these" categories, or "all of these". Thus various dimensions of informality mixed.
Günther and Launov 2006	"informal sector comprises the active population which is neither employed in the public nor in the private formal sector"	Residual method: easy to measure.	Very rough estimate, rather imprecise.

Two main views in defining informal employment are identified: i) the productive definition and ii) the legalist definition (see Gasparini and Tornarolli, 2007 for more details). The productive definition takes as starting point the production unit where a worker is employed, in the fashion of the 1993 ILO definition of informality. Informality

in this sense is conceived of as engagement in marginally productive activities, and normally the type of job is used as an indicator for informality (e.g. self-employed or employment in a micro-enterprises).

On the other hand, the ‘legalist’ (or ‘social protection’) definition aims to capture the extent to which workers are covered by labour contracts, social protection, taxes and other regulations. The more recent ILO definition on informal employment is more in this tradition as it takes exactly these dimensions as criteria for informality of jobs. Clearly, however, social protection coverage is not the same as having a labour contract or tax compliance. For practical reasons, studies normally tend to take only one of the dimensions as criterion for informality. When comparing the legalist definition with the productive one, clearly there are important differences. Note for example that according to the productive concept workers are by definition less productive, but this doesn’t necessarily apply to legalist definitions

As Table 1 shows, very diverse indicators for informality are used. The first definition (Loayza and Rigolini 2006) takes “informal activity” as a starting point, where workers are often low-skilled and unregistered. This is proxied by the share of self-employment in the economy. Some other authors have also used a definition based on the employment category or on the type of firm employing the worker. On the other hand, other indicators are based on the coverage of the worker by a labour contract or social security. These two types of definitions of informality used are sometimes referred to as respectively the “productive” and the “legalist” definition (see Gasparini and Tornarolli, 2007).

While some official definitions exist on informality, in practice a variety of definitions is used to describe the phenomenon of informality. As Gasparini and Tornarolli (2007) stress, it is important to remember that the different definitions do not so much represent different views on informality; they rather refer to different *phenomena*. In this paper we will mostly use the standard ILO definition of informal sector, i.e. micro and self employment. Informal economy refers to unregistered and/or untaxed economic activity and informal employment to workers with no contract and no social security coverage.

2.2. Puzzling evidence

2.2.1. The complexity of informal employment

Measuring and studying informal employment is not easy. First the definition of informality, quite complex in itself as it has been highlighted in the previous section, determines the measurement of informal employment. Most importantly, different definitions may give very different results and can give completely different pictures of reality even within one country examined. Informality can no longer be described as a zero or one phenomenon. It can comprise a range of one or few informal features to many different informal characteristics of employment. Moreover informal employment can be very heterogenous, with workers being informal in many different ways and dimensions and different informal groups may have little or no characteristics in common. What is more, informal workers can have a footing in both sector at a given point or can switch

among sectors over time. In fact traditional models which tended to present the informal and formal sectors as two clearly separate markets with no or little exchange or overlap (e.g. Lewis) do not fit reality anymore. This dichotomy is not clear cut which can make informal employment an even more complex and diverse phenomenon.

Definition and measurement matter

In theory it should not be difficult to measure the different dimensions of informality mentioned in section 2.1. However in practice this strongly depends on data availability. The most common⁴ way to measure the size of informal employment is through household surveys. As a result, survey questions can dictate the definition used by researchers. When comparing informal employment statistics, a number of issues should therefore be kept in mind. First, often survey based measures have to rely on rather imperfect estimates, which describe only one element/dimension of informality (see Table 1). Secondly, national statistical offices have not yet standardized their definitions to international standards (where available), survey questions are raised in different fashions and social security systems can be quite distinct. Therefore, international comparisons are often not accurate (ILO 2002a, 2002b,) or need special care.

In case comparisons are made across different definitions, clearly the differences have to be taken into account. Even if the percentages of informality definitions are quite similar, it should be remembered that they can refer to very different groups of people, between which the overlap is far from perfect. As an illustration, one study (Henley et al. 2006) investigates the overlap of three definitions of informality extracted from a Brazilian survey, i.e. (1) the absence of a registered labour contract, (2) the absence of pension coverage, and (3) informality as micro-activity. While shares of informal employment for 2001 ranged only from 49.3% to 56% according to the different definitions, these percentages referred to different groups with incomplete overlap. In fact, only 39.6% of the sample could be categorized as informal according to all three criteria (a strict definition). However, according to a broader definition (at least one criterion of informality), informal employment would be over 63.6%.

Informality: not a dichotomous phenomenon

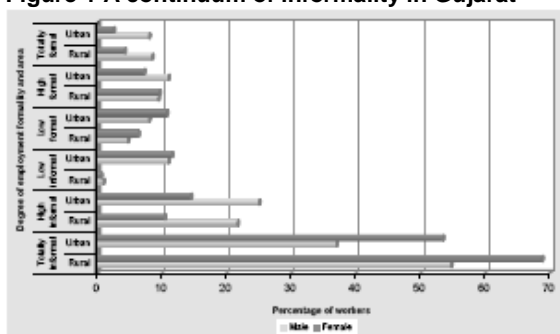
From our discussion it seems that by defining and measuring informality in one single dimension we miss out an important share of information. Because informal employment can be very diverse and its consequences in terms of development, well-being and poverty can vary in significant ways, it is important to acknowledge the

⁴ Furthermore, more indirect and rather inaccurate measures are sometimes used. First, there is the residual method, where informal employment is estimated by subtracting from the entire active population the number of formal jobs (see ILO 2002a). Another (very unsatisfactory) way is to use a proxy for informal employment through taking the working poor (ILO 2007b, footnote 6).

multidimensionality of informality. At the same we should also highlight the various degrees of overlap of the different dimensions used and hence present informality as a continuum. A recent ILO report (ILO 2004a) proposed continuum of informality with the following five dimensions: regularity status, contract status, workplace status, employment protection status and social protection status. On the basis of these 5 dimensions, people receive scores ranging from 0 (totally informal) to 5 (totally formal). For the countries with available data, the results give an interesting picture of the complexity and diversity of informality across countries.

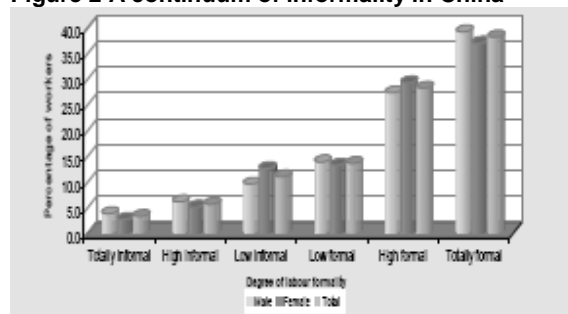
Figure 1, Figure 2 and Figure 3 display this score of informality for the Indian state Gujarat, China and three Latin American countries (Argentina, Brazil and Chile). While in Gujarat the vast majority of the workforce is informal according to all five dimensions, and only a very limited share is totally formal, an important share of people are somewhere in between. On the other hand, in China a relatively rather large percentage of people is totally formal, and very few people have totally or high informal jobs. Still the majority of people are in some way(s) informal. In Latin America, a large share of people is not completely informal or formal, but rather somewhere in between.

Figure 1 A continuum of informality in Gujarat



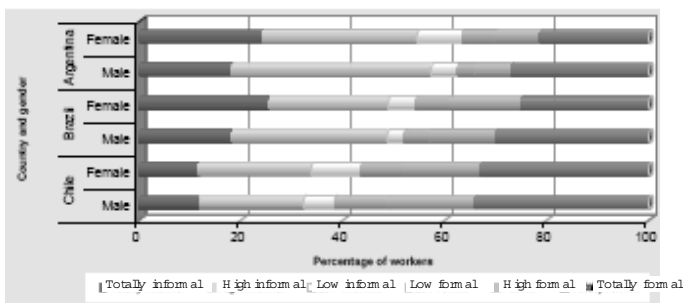
Source: ILO 2004a

Figure 2 A continuum of informality in China



Source: ILO 2004c

Figure 3 A continuum of informality in Argentina, Brazil and Chile



Source: ILO 2004b

Heterogeneity of informal workers

Whichever definition is chosen, informal employment includes many different types of workers, ranging from marginal self-employed own-account workers, to well-off entrepreneurs who employ others, and from informal employees of informal or formal firms to contributing family workers (see page 4-5).

Table 2: Wage and self-employment in non-agricultural informal employment, by sex

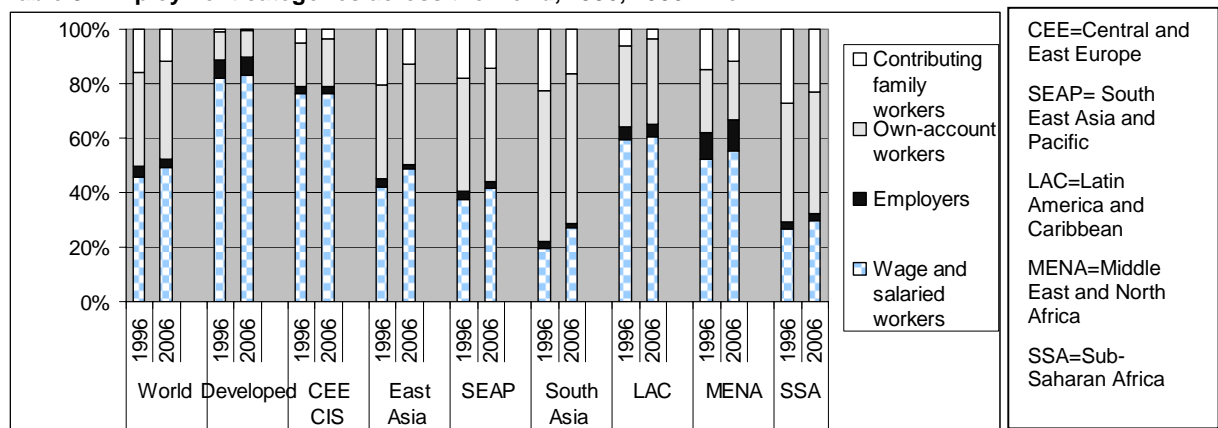
Country/Region	Self-employment as a			Wage Employment as a		
	Percentage of Non-agricultural			Percentage of Non-agricultural		
	Total	Women	Men	Total	Women	Men
North Africa	62	72	60	38	28	40
Algeria	67	81	64	33	19	36
Egypt	50	67	47	50	33	53
Morocco	81	89	78	19	11	22
Tunisia	52	51	52	48	49	48
Sub-Saharan Africa	70	71	70	30	29	30
Benin	95	98	91	5	2	9
Chad	93	99	86	7	1	14
Guinea	95	98	94	5	2	6
Kenya	42	33	56	58	67	44
South Africa	25	27	23	75	73	77
Latin America	60	58	61	40	42	39
Bolivia	81	91	71	19	9	29
Brazil	41	32	50	59	68	50
Chile	52	39	64	48	61	36
Colombia	38	36	40	62	64	60
Costa Rica	55	49	59	45	51	41
Dominican Republic	74	63	80	26	37	20
El Salvador	65	71	57	35	29	43
Guatemala	60	65	55	40	35	45
Honduras	72	77	65	28	23	35
Mexico	54	53	54	46	47	46
Venezuela	69	66	70	31	34	30
Asia	59	63	55	41	37	45
India	52	57	51	48	43	49
Indonesia	63	70	59	37	30	41
Philippines	48	63	36	52	37	64
Syria	65	57	67	35	43	33
Thailand	66	68	64	34	32	36

Source: ILO 2002a. Data are for 1994/2000.

Informal self employed and wage employees are easier to identify and are thus relatively well documented. Table 2 displays figures⁵ on wage and self employment in non agricultural informal employment for 25 countries across the world. It shows that in all regions self-employment is larger than informal wage employment, but this is especially the case in Sub-Saharan Africa. A gender perspective is also very insightful. In 14 out of 25 countries presented in this table, self-employment of women is higher than for men. Note also that there is much variation within continents. For example, there is a remarkably low rate of self-employment in South Africa (25% vs. the 70% average). This can be understood as a legacy of the apartheid regime which prohibited blacks from owning their own business (ILO, 2002a).

Table 3 and Table 4 display a more detailed picture on employment categories, decomposing self employment into family work and own-account work. In comparison to Table 2, these tables do not focus on informal employment. Although own-account workers and contributing family workers are informal according to any type of definition, it is not the case with wage workers and employers which can be both informal and formal. Nonetheless, what is obvious is that contributing family workers but especially own-account workers constitute a very large share (sometimes the single largest) of total male employment. Women are more often contributing family workers. For example, between 38 and 48% of women are contributing family workers in South Asia, whereas this is only about 20% for men who are mostly own-account workers (56%). In addition, we can witness some changes over time. The share of wage employment in total employment has somewhat risen, especially at the expense of contributing family workers. For example in MENA there has been an 8 percentage points increase in the share of women in salaried employment between 1996 and 2005.

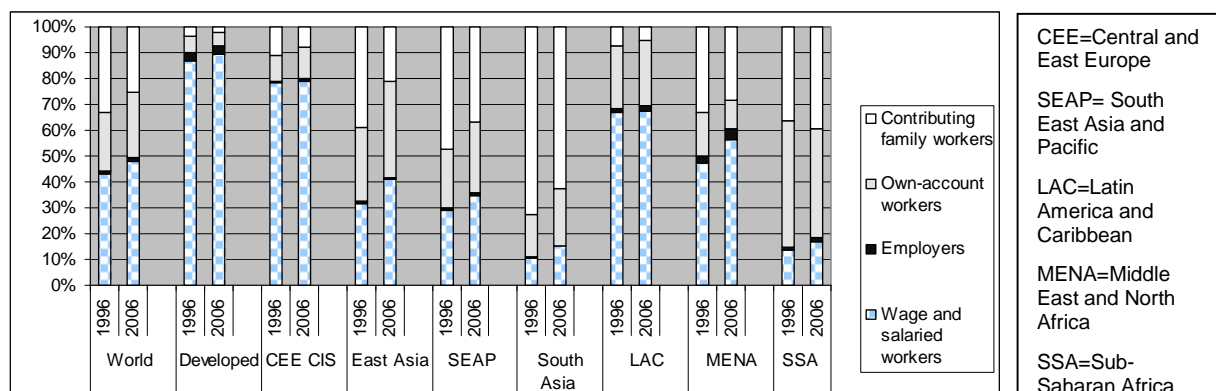
Table 3: Employment categories across the world, 1996, 2006 - men



Source: ILO 2007a

⁵ These figures are estimations based on the residual method, as discussed in footnote 2. For more information see ILO 2002a.

Table 4: Employment categories across the world, 1996, 2006 - women



Source: ILO 2007a

The fuzzy line between formal and informal

Apart from the fact that informal employment has many dimensions, and informal work can refer to a variety of occupational groups, even at the individual level, formal and informal work often overlap. This is because workers can often combine formal and informal work, and can also switch among the two over time.

Table 5: Primary vs. secondary informal job holding in 5 countries

	<i>Informal employment as...</i>	
	1 st job	2 nd job
Barbados	88.6%	11.4%
Georgia	97.2%	2.8 %
Kyrgyzstan	97.6%	2.4%
Lithuania	77.5%	22.5%
Russian Federation	79.7%	20.3%

Source: ILO 2002b. Data are for 1998-2001.

As to the first, it is well-known that many workers combine formal and informal work; however it is hard to establish the extent of the phenomenon (Chen, Vanek and Carr, 2004). Table 5 shows for a limited number of countries whether informal work is done as main or as secondary activity. In some countries an important share of people are engaged in informal employment as addition to their formal job. This is as high as 22.5% in Lithuania and 11.4% in Barbados. In some other countries, this share is much lower. The overlap between formal and informal activities is even more pronounced if we take the household or the family s the unit of analysis. It is indeed the case that many families decide on the division of labour within the household on the basis of expected returns and

often choose a smart combination of informal and formal work along with other forms of income generating and risk management activities such as migration.

2.2.2. Informality on the rise

The ILO has gathered a large amount of information on informal employment according to its original definition⁶. These statistics are summarised in

Table 6, which presents evidence on the size of employment in the informal sector in various regions. Before discussing the evidence in

Table 6 we should repeat that across country and time comparisons should be made with caution as definitions and measurement methods may not always allow credible comparisons. The resulting picture in

Table 6 is clear. First, informality differs substantially across regions, ranging in 1980-89 from 38.8% in North Africa, to 68.1% in Sub-Saharan Africa. Secondly, informality according to this definition has increased over time in all regions⁷. The biggest rise has occurred in North Asia, followed by Africa.

Table 6: Employment in the informal sector

<i>Region</i>	Informal sector as % non-agricultural employment	
	<i>1980-89</i>	<i>1990-99</i>
North Africa	38.8	43.3
Sub-Saharan Africa	68.1	74.8
Latin America	52.3	56.9
Asia	53.0	63.0

Source: Beneria, 2001

⁶ To be precise, it includes all non-agricultural “unincorporated enterprises owned by households”, micro-enterprises, professional, domestic workers, and home-based workers; family labour and “employees on an occasional basis.

⁷ It would be interesting to know whether changes in informality can be attributed to changes of informality within sectors, or to sectoral changes in the economy. This second possibility is relevant as some economic sectors are especially prone to informal employment relations (e.g. domestic servants and construction workers, and non-tradables in general) and an increase in the relative share of this sector in the economy would lead overall informality to increase. Evidence from Latin America suggests that a large part of the increase in informality observed can be attributed to increases within sectors. For example, Bosch and Maloney (2006) find that of a 4% increase in informality in Mexican labour markets from 1991-5, and its return to its original level in 2001, respectively 91% and 90% can be attributed to changes within the sectors. A similar picture arises for most other Latin American countries (Gasparini and Tornarolli 2007).

Table 7: The informal economy, various years

Region	Informal economy as % GDP		
	1989/90	1999/2000	2002/2003
OECD (21 countries)	13.2	16.8	16.3
<i>Greece</i>	22.6	28.7	28.2
<i>United States</i>	6.7	8.7	8.4
Central European and Former Soviet Union Countries (25 countries)	-	38.1	40.1
<i>Georgia</i>	-	67.3	68.0
<i>Slovak Republic</i>	-	18.9	20.2
Africa (23 countries)	-	41.3	43.2
<i>Zimbabwe</i>	-	59.4	63.2
<i>South Africa</i>	-	28.4	29.5
South America (21 countries)	-	41.1	43.4
<i>Bolivia</i>	-	67.1	68.3
<i>Chile</i>	-	19.8	20.9
Asia (28 countries)	-	28.5	30.4
<i>Thailand</i>	-	54.1	52.6
<i>Singapore</i>	-	13.1	13.7

Note: regional values are unweighted averages.

Source: Schneider 2002, 2006.

In Table 7 we report statistics⁸ on informal employment over time where informal economy is defined on the basis of unregistered activities. As can be clearly seen from the table, the highest share of the informal economy is found in Africa and South America with (around 42%). The OECD countries rank last with a non negligible 16.8%.. As the variation within each group can be considerable, the table also displays respectively the highest and lowest value per group⁹. The table also shows some trends over the years, and this trend is clearly an upward one. However, for most regions except the OECD data are only available for limited time stretch and this upwards trend should thus be interpreted with scrutiny.

Systematic information on informal employment according to social protection or contract for all countries is not available. Table 8 does however show informal employment for selected Latin American countries according to a definition based on social protection. It displays estimates of the share of workers without social security

⁸ The indirect methods are based on physical inputs (e.g. electricity use), currency demand or a model approach combining several factors. See Schneider 2002 for a more thorough presentation of the various measurement methods and a discussion of their respective strengths and weaknesses.

⁹ In case the ranking changes over time, we display the country with the lowest/highest informal economy share in the latest year available.

entitlements, based on household survey data from 1995-2004. While in some countries informality according to this definition has declined or remained stable, in the majority of countries there has been a sustained rise, especially since 2000. More in general, studies tend to confirm a rise of informal employment or at the very least no decline¹⁰.

Table 8: Share of salaried workers with no social security rights, selected Latin American countries, 1998-2004 (in percentage)

	1998	1999	2000	2001	2002	2003	2004
Argentina	37.9	38.3	38.5	38.7	44.1	44.9	
Brazil	36.4	36.7		35.9	36.1	34.8	35.0
Chile	22.9		23.7			22.4	
Colombia		75.1					
Ecuador	60.7					72.2	
El Salvador	48.5		47.0	48.0	45.4	48.2	50.3
Guatemala			65.6		59.9	62.8	64.9
Jamaica		74.6					
Mexico	57.8		55.0		59.0		60.2
Nicaragua							
Paraguay		73.8		72.6	73.8	74.4	76.8
Peru		77.2	77.3	73.2	71.9	70.2	
Uruguay				23.2	23.7	25.8	27.6
Venezuela	35.4		31.9	35.6	38.9	41.6	40.2

Source: Socio-Economic Database for Latin America and the Caribbean (CEDLAS and the World Bank). For Argentina, only data for the survey in 28 cities are displayed. For more info see <http://www.depeco.econo.unlp.edu.ar/cedlas/sedlac/>

2.2.3. Informality can be beneficial

Earnings relative to the formal sector

It will come as no surprise that informal employment is generally associated with lower wages than formal employment (Chen, Vanek and Carr, 2004; Perry et al. 2007; Gasparini and Tornarolli 2007; Bosch and Maloney 2006). However, this aggregate phenomenon conceals some interesting particularities. This situation is illustrated with a study on Mexican informal and formal employment (Figure 4). Informality is defined here as a lack of contributions by the employer to the social security agency, and two groups are distinguished: informal salaried and informal self-employed. In Figure 4 earnings are displayed relative to formal salaried workers. Two things stand out. First of all, at some point in time, earnings of the informal self-employed were actually higher than those of formally employed workers. For some people informal employment can thus work out quite well. Secondly, relative wages can change much over time. The earnings of the self-employed were over 20% higher than those of the formally employed

¹⁰ See e.g. ILO 2004; Perry et al. (forthcoming) for Latin America; Chen Vanek and Carr 2004.

in 1990, but fell to less than 80% in 1997-8. The same variability applies to informal workers.

Figure 4: Relative earnings informal / formal sector, Mexico 1987-2002



Source: Bosch and Maloney, 2006

This picture is compatible with other evidence. Other studies also argue that some informal workers are not worse off than formal workers and that informal employment earnings can vary enormously (Günther and Launov 2006; Maloney 1999; UNIFEM 2005). This highlights the need for a detailed examination of informal employment as it can vary enormously from one sector or type to the other and hence rank differently compared to a similar formal job.

Within informal sector earnings

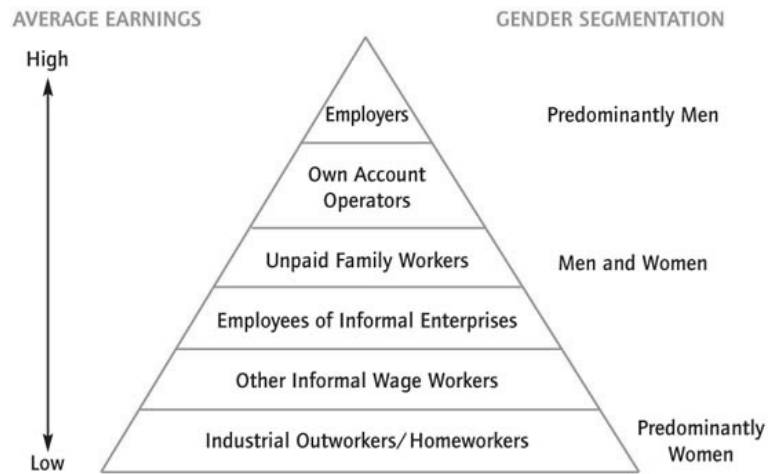
From the above it also follows that the relative wages of informal workers differ according to the employment category within the informal sector. This observation could also help to reconcile the heterogeneous evidence shown in different papers which use different definitions of informal employment. Indeed, it is well documented that there are important differences in earnings between the various groups¹¹. Chen, Vanek and Carr (2004) propose the following pyramid to describe the earning status of various informal employment groups (Figure 5). While employers can have a relatively good income, some groups such as home workers are much worse off.

This figure highlights the distribution along gender lines. In general, men are more represented at the top of pyramid (employers, micro-entrepreneurs), and women more as

¹¹ See Chen Vanek and Carr, 2004; Perry et al. (forthcoming); UNIFEM 2005; Gasparini and Tornarolli 2007.

unpaid family workers and home workers (for this see also Table 3 and Table 4). What follows is thus also a gender gap.

Figure 5: Average earnings per informal employment category



Source: Chen, Martha Alter, Joann Vanek and Marilyn Carr. 2004

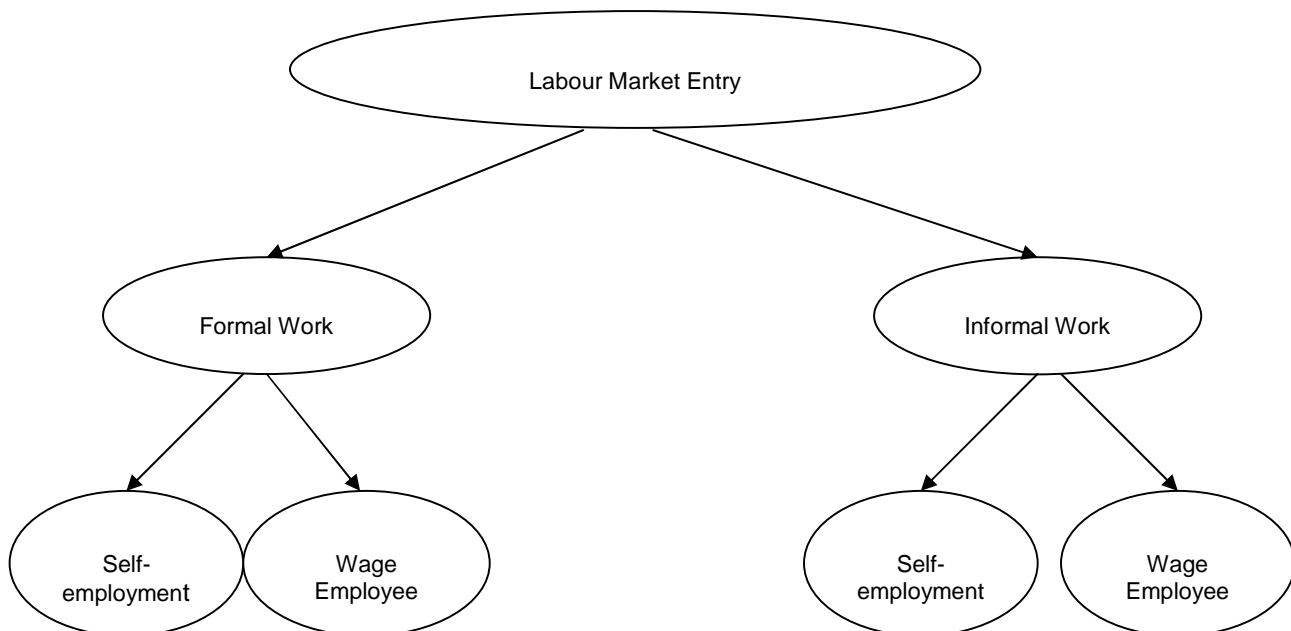
3) UNDERSTANDING INFORMAL EMPLOYMENT: TOWARDS A NEW ANALYTICAL FRAMEWORK

3.1. A simple framework of informal employment

A model which has occupied a central position in the debate about informal and formal employment is that of dual or segmented labour markets (e.g. Lewis 1954, Harris and Todaro 1970). Rigidities in the formal sector of the economy lead to the creation of a second, informal sector of work, which attracts many of those who cannot get a formal job. Segmented labour markets may be further related to barriers to labour mobility, efficiency wages. Individuals working in the informal sector would have preferred to work formally, but are rationed out due to labour market segmentation. Hence the informal sector is described as a sector of exclusion or a sector of last resort for individuals with low skills and weak prospects of finding jobs in the formal sector.

The simple conventional framework of labour market selection (including informal work) is shown in Figure 6. Once the decision to enter into the labour market is taken, individuals are selected in formal or informal employment. In a second stage, a choice of the type of employment is made. In a simplified way, this is a choice between a salaried job and self-employment.

Figure 6: A simple conventional framework of labour market decisions



3.2. Challenging the conventional model

The previous section has provided recent evidence which challenges the conventional view of the informal labour market. Emerging evidence suggests that a share of informal employment is voluntarily chosen and may offer specific benefits and opportunities to certain individuals. In particular, depending on their characteristics, some individuals may have a comparative advantage to work in the informal sector (Günther and Launov 2006). Moreover, many individuals and households may engage in innovative combinations of informal and formal work as risk-coping and income-generating strategies. Thus the conventional way of thinking about informal employment does not seem to fit the emerging evidence and a revised, more complex model, may be needed.

Workers choose the sector and type of employment which maximises their utility. This utility depends on the individuals' characteristics and their preferences, where preferences can be broadly defined to include both pecuniary and non pecuniary aspects of work. In fact, pay and job security, although they are important determinants of utility, are not the only ones. Other factors such as autonomy, flexibility, working hours, distance to work and opportunities offered in the informal sector also determine job satisfaction (Mulinge and Mueller 1998) and may make workers choose informal employment (Saavendra and Chong 1999). Overall, in similar ways as in developed countries, well-being considerations may be very important in shaping employment strategies and individual choices. Individual preferences with regard to pay and non monetary job characteristics vary in important ways and are often shaped by family constraints as well as individual tastes.

Indeed a recent view sees the informal sector as a sector where workers are self selected voluntarily because of the various benefits and advantages that it can offer, or because of the comparative advantage they may have in informal employment. According to this view workers weight the costs and benefits from working informally versus working in the formal sector and choose the first based on their characteristics and preferences. We should note here, though, that individuals who are voluntarily informal, are not necessarily well off or not poor. Their choice of informality over formal work reveals that, for some reason, they are better off in that position. Maloney (2004) uses data from Latin American countries and provides evidence that about 60% of people in informal self-employment left their previous jobs and engaged in self-employment in a voluntary manner.

However, not all people in the informal sector are there by choice. In fact another strand of the literature sees the informal sector as a two-tier sector: the upper tier is reserved to those who prefer informality over a job in the formal labour market and a lower tier composed of those who are there because of no other alternatives (Fields 1990, 2005). For example, Perry et al. (forthcoming) show that in selected Latin American countries, the bulk of the self-employed in the informal sector have moved to that sector voluntarily whereas most informal wage employees are found in the informal sector because they are excluded from formal activities. However, Perry et al. argue that even within this segment of the informal labour market, we can find workers who have voluntarily taken

this option. Evidence in favour of “a tale of 2 tails” is also found in Yamada (1996) for Peru and Günther and Launov (2006) for Ivory Coast.

A review of the existing literature in developing countries reveals some interesting features of informal workers (Table 9 provides a short summary of the evidence in the literature). Young workers are mostly found to work as informal paid workers and this is especially true for the less educated ones who have no chance of getting a job in the formal sector (Saavendra and Chong 1999). Older workers are often self-employed in the informal sector. They may be more willing to switch to the informal sector as the trade offs may be less difficult for them. For example, heads of older households, with sons and daughters already working in the formal sector may have to worry less about the benefits (social protection) of formal coverage, as their children’s coverage is often extended to the entire family. The picture in the formal sector is quite mixed, with both young and middle aged individuals working in the sector.

Table 9: Profile of formal employee, informal sector employees and self-employed

	Formal Sector	Informal Sector	
		Self-employed	Salary workers
Age	+/-	+	-
Education	+	+	-
Experience		+	-
Married women	-	+	+
Single women	+		
Children		+	
Household members in formal jobs		+	+
Poverty			+
Firm size	+	-	-
Sector		Construction, transport, agriculture, trade	Construction, transport, agriculture, trade, services

Women are over-represented in the informal labour market (Maloney 2004), both as salaried workers and self-employed. This may be linked to the limited opportunities women in some countries have or, for example, to the downsizing, in many countries, of public employment, which traditionally has been the main destination of women in the labour market. On top of that, and in line with our story that non pecuniary job characteristics matter, it may be that women value the flexibility and autonomy that informal work offers as it allows them to combine more easily work and family responsibilities. Recent evidence (Perry et al., forthcoming) shows that single women are the most likely group to be in formal employment relative to married women and men. Among married women, those with more young children are more likely to be self-employed in the informal sector, which also suggests a link between family responsibilities and the choice of informal work, in particular self-employment. Maloney (2004) shows evidence from Argentina, Mexico, Costa Rica and Brazil that women with young children are more likely to be self-employed than formal sector employees. Household composition seems to play an important role in choosing the informal sector.

Gonzalez de la Rocha and Gantt (1995) show that heads of young families are more likely to be in manufacturing (formal sector) whereas heads of older families can move to riskier but better rewarded jobs as other household members can hedge against risk.

Education is an important factor determining selection into the formal or informal sector. Individuals with no, or minimum education are mostly wage employees in the informal sector. Some of the highly educated find employment in the formal sector whereas others become self-employed in the informal sector (Saavendra and Chong 1999). This last group may be choosing to move to informal business for various reasons that we will discuss later.

The evidence on age, education and other individual and household characteristics supports the idea of a life cycle model at the individual level. Individuals start with some years of work in the formal sector or the informal sector (as wage workers), until they accumulate the necessary physical and human capital to leave for the informal sector (Maloney 2004). This idea is indeed consistent with the finding that older and middle-aged individuals constitute the majority of self-employed in the informal sector. On the other side, young workers, who have the necessary human capital, get a job in the formal sector. However, for unskilled and disadvantaged young individuals, the main entry point into the labour market remains the informal sector. They stay there, often changing employers, until they accumulate the necessary savings, and possibly human capital, to move to self-employment.

3.3. Costs and risks associated with work in the informal sector

Work in the informal sector is often associated with important costs and risks. Informal workers are over represented among the poor, although it is not very clear which way the causality runs. Work in the informal sector may be related to chronic poverty (the chronic poor). The costs and risks associated with informal sector work are summarised in Table 10 and can be classified in four main groups of costs and risks in informal work:

- **Uncertainty and vulnerability:** Informal work is characterised by higher uncertainty in terms of income flows as well as informal contract renewal and may be associated with higher unemployment risk (Duryuea et al. 2006). Informal activities are often seasonal and thus dependent on weather conditions and natural disasters.
- **Lack of benefits:** informal workers lack social protection and other basic benefits such as overtime compensation, severance pay, unemployment benefits, sick leave) and social protection. Furthermore they have no entitlements for any public social security e.g. accident, health, pensions. An ILO study (Lee 1998) shows how employment insurance would have cautioned workers against falling into poverty in the Asian financial crisis.
- **Work conditions:** informal sector workers may work longer hours and are often exposed to occupational hazards and work accidents. Because unions and workers' association, when they exist, tend to be less powerful than those in the

formal sector, workers' rights are not always satisfied. Besides, informal sector employees have less chance of accessing formal training.

- High costs: starting up an informal business may require the payment of a significant amount of money as an entry fee. In addition, it may entail prior investment in physical and human capital. Finally, sustaining an informal business can be costly. Although informal entrepreneurs do not pay taxes and contributions, they often pay high fees e.g. in terms of bribes.

Table 10: Costs and risks associated in informal employment

	Informal Sector	
	Self-employed	Salary Workers
Poverty, exclusion, vulnerability	?	✓✓
Uncertainty in terms of future earnings	✓	✓✓
Uncertainty in terms of contract renewal		✓
Uncertainty in terms of enterprise survival	✓	
Lack of basic benefits (severance pay, overtime, unemployment benefits, sick leave) and social protection	✓	✓
Long working hours		✓
Occupational hazards/ work accidents		✓
Absent (or weak) workers' organisation		✓
High entry cost	✓	
High indirect operational costs (e.g. bribes)	✓	

3.4. Benefits and opportunities of working in the informal sector

In this section we briefly review the evidence to show that there are benefits and opportunities associated with at least some forms of informal employment. These benefits go beyond the standard arguments of tax and various contributions avoidance (Cichello et al. 2006 for South Africa). Although small enterprises owners may partly choose to stay informal because of fiscal reasons, they may also do so because of other potential benefits of informality. These can range from more flexibility with the work to more autonomy and less administrative burden. It is important to note that these benefits do not equally apply to all people working informally. However, even those individuals who are found in informal work without having chosen it benefit from some of the opportunities that informal employment may offer. Inefficiencies in formal sector protection and low levels of labour productivity may make informal sector employment a better option for some people (Maloney 1999). The benefits and opportunities offered by informal employment can be summarized in the following categories:

- Higher pay: individuals with specific characteristics may have a comparative advantage in informal employment. This comparative advantage may be translated into higher earnings compared to potential earnings in the formal sector. Evidence from Mexico (Maloney 1999) shows that movement from self-

employment or contract work into formal salaried employment is associated with a decline in wages whereas movement from formal salaried to self-employment or contract work leads to a significant increase. Furthermore, movement from formal salaried and informal salaried work into self-employment is associated with a substantial and significant increase in wages.

- Greater flexibility and autonomy: individuals working in the informal sector benefit from flexibility in terms of working hours and in some cases choice of work location. This aspect may be especially valued by women with children who need to combine work and family. Working from home may be very interesting for women in some countries, when their physical mobility is constrained by social norms.
- Low quality of services and benefits provided by the formal sector: for example social security may not exist or may be of a very poor standard, there is uncertainty about the payment of future pensions. High administrative costs combined with low quality of services may discourage some workers from getting a job in the formal sector (Maloney 1999). This is especially true for young workers who tend to be more myopic than older workers, and hence value less old age payments such as pensions. Finally, even within the formal sector there is a high degree of turnover and thus workers often do not benefit from their seniority benefits and pensions (Maloney 1999).
- Some “protection” in the informal sector: contrary to the general perception, in some cases the informal sector may not be uncovered/unprotected. For example, sometimes labour market policies such as minimum wages are binding in the informal sector. Various studies (Lemos, 2004, Maloney and Nuñez, 2003 etc.) have found that minimum wages have a significant impact on informal wages in Brazil and other Latin American countries. Furthermore, the household may find alternative ways of social protection at the household or family levels. For example, within a family the optimal strategy may imply formal employment for one or more members which may provide social protection and other benefits to the entire family, and informal employment for the rest of the family. Galiani and Weinschelbaum (2006) find that secondary workers are more likely to work in the informal sector if someone in the household has a formal job. In the same line, Maloney (1999) argues that the marginal value of formal sector benefits for a second worker in a household may be zero, which could go some way in explaining why individuals in larger households may choose work in the informal sector.
- Training opportunities and access to informal networks: working in the informal sector may be the only chance of accumulating experience or even of training and apprenticeship for low-skilled young workers or unskilled older individuals. Besides, talented workers may have better prospects for upward mobility in the informal sector. Finally access to informal networks through informal employment can in certain cases be effective in providing some sort of unemployment and health insurance.

Table 11: Benefits and opportunities in informal employment

	Informal Sector	
	Self-employed	Salary Workers
Flexibility, Autonomy	✓	
Working hours flexibility, choice of work location	✓	✓
Higher potential earnings	✓	
Training opportunities	✓	✓
Accumulation of work experience	✓	✓
Career prospects/ upward mobility	✓	?
Access to social networks	✓	✓
Tax, social security and other contributions avoidance	✓	✓
Low quality and high uncertainty of formal sector benefits (e.g. social protection, pensions)	✓	✓

3.5. Towards a more complex framework of informal employment

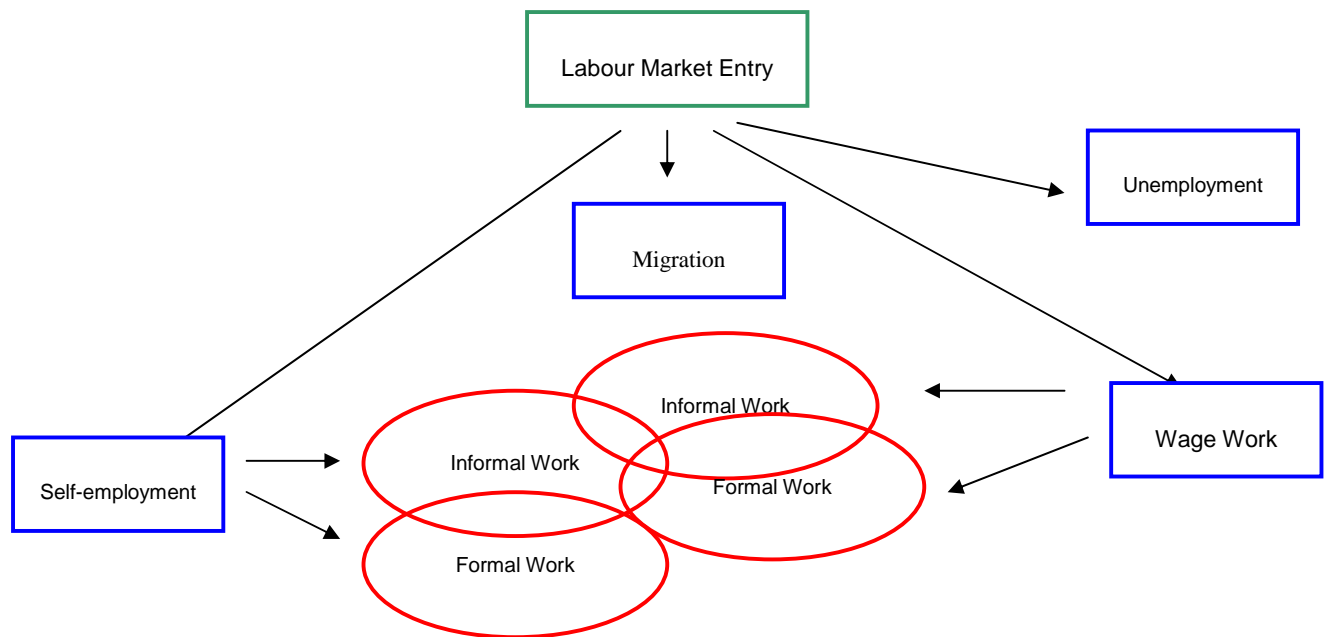
Having briefly reviewed the evidence on the attractiveness and risks of informal employment, one main issue prevails: the selection of individuals across sectors and types of employment cannot be described in a simple framework as it was presented in Figure 6. Many other factors need to be taken into account. For instance migration, either internal or international, is a major household risk-coping and income generating strategy and it should be also included in the framework. Moreover, informal work, formal employment and migration often coexist within a given household. More importantly they can also be used together by the same individual wishing to maximise his or her utility and income. Given the complexity of the issue and the vast variety of possible types of informal activities and employment, the simple framework presented earlier is not likely to fully capture the selection of individuals across the different types of employment.

First it is important to add migration into the picture. Migrating within the country or abroad is a common and increasingly used strategy to cope with risk and increase household income. Second, it seems that the decision individuals have to take is not so much a choice between formal and informal employment, but rather the choice between salaried work and self-employment. Consequently in Figure 6, we provide a simple revised model of labour market decisions in two stages. Once the decision to enter into the labour market is taken, the decision must be taken whether to migrate, to become paid workers or to become self-employed (a fourth labour market state includes unemployment). In a second stage, the selection in formal or informal employment takes place.

The choice among different forms of employment and income generating strategies is determined by the characteristics of the labour market and the economy and hence the characteristics of potential jobs. However on top of that, individual characteristics and preferences determine the choices than individuals make between self-employment and wage work, informal and formal employment or migration.

Figure 7 shows areas of intersection between different types of employment. For example, a formal worker may have a small informal (family or not) business and/or can be engaged in an informal paid activity. Distinguishing among these various activities can be difficult, especially given the available data source, mostly household surveys which only report the main occupation and activity of the respondent.

Figure 7: Elements of a revised framework of labour market decisions



The above framework can potentially describe not only the individual decisions but also those of the households or the extended families. This may be appropriate given that often the choice between formal and informal employment depends on the household structure and the labour market status of other household members. The benefits and costs of work in the different sectors are viewed in light of the household composition and the labour market status of other family members. Moreover the life cycle model briefly discussed in the previous paragraphs can be extended to the household level. As time goes by, the size, education and age composition of household members change and, along with it, labour market choices may change. In addition migration history or tradition in the household can determine future choices.

4) AN EMERGING AGENDA: POLICY AND RESEARCH CHALLENGES

Using a well-being approach, this paper critically assessed the literature on informal employment, aiming to capture all elements relevant for understanding the persistence of this phenomenon. As it turns out, broadening the analytical framework beyond an income- or earnings-centred approach has proved a very useful exercise for explaining puzzling trends in labour market developments. Of these puzzling trends, the following stand out:

- Informal employment is on the rise. It is clear by now that growth doesn't lead necessarily to a reduction of informal employment. In most regions and sectors informality is on the rise – be it with different degrees and intensities.
- The formal and informal dichotomy gets blurred. Many people have a footing both in formal and informal employment, so a clear-cut separation between the two sectors is no longer possible. This trend is fuelled by an increasing informalisation of the formal sector in particular in middle income countries due among others to the down-sizing of the public sector and the increasing importance of the service industry in which low-paid jobs are frequently found. This has led to people working in formally registered companies but do not getting money to pay for their living. The dramatic increase of the working poor poses serious challenges for societies.
- Informal employment is not necessarily bad. The long-held view associating “informal employment” automatically with low-paid jobs, exclusion, low quality of work etc. often does not seem to match reality. Besides the well known arguments of tax evasion, higher earning potential and less regulatory constraints for the self-employed, this study also finds ample evidence that informal workers might also benefit from quite different elements of informal work: access and strengthening of family networks and thereby producing and using social capital; more flexibility and often a less risky way of generating income. Besides, the benefits often associated with being employed in the formal sector – access to social security benefits, job security, higher wages and earnings, etc. – are increasingly seen as by no means certain or given.

Based on the review of the evidence on informal work, the following policy and research challenges emerge:

- Improving data collection

Section two has shed some light on the poor state of informal labour market statistics. Therefore, there is a need to improve data collection and quality in the area of labour markets, employment and vulnerability. Existing data sets are scattered, often of a very low quality and out-dated. In particular, regular up-dating and monitoring is missing. Improving statistics and measurement tools to assess properly labour market conditions is crucial for informed policy-making.

Informed policy decision hinges critically upon knowledge. Once data collection and quality is being taken care of, clear indicators should be constructed and selected to capture the realities on the ground. In this, the complexities of informal employment should be well taken into account. For example it should be remembered that often individuals are not either formal or informal but can be both, at the same time or across time. Similarly, it should be taken into account that the individual is not always the appropriate level of analysis, as households or extended families often design strategies together. The World Bank together with the University of Cornell has started an interesting project to revise and test new indicators and more such kind of initiatives are most welcome.

- Understanding realities on the ground

There is a need to further analyse in depth the determinants of informal employment and its composition through cross-country studies. Leading questions could be: can we observe a pattern in the size and the composition of informal employment in low- and middle-income countries? What can we say about factors influencing this pattern – e.g. trade openness, labour market regulation, institutional environment and history? What determines individual choices? To opt for informal employment can be a voluntary choice and people are not necessarily worse-off compared to those working in the formal sector. Hence there is an urgent need to understand better why different groups within the informal sector, such as the self-employed, wage employees, women, men and youth, choose to stay or to go. A critical issue, of course, remains that some apparently do not have any choice at all other than staying informal. Besides the poor and un-educated, there is emerging evidence that some marginal groups of society are systematically excluded. We need to better understand what holds them away and how we can remedy these bottlenecks. Finally, it is equally important to undertake a dynamic analysis. In order to be able to detect causalities the time dimension needs to be added. Of particular interest are the formal–informal linkages as well as the interaction between self-employed and wage employed within informal employment.

- Identifying better policies, instruments and good practices to handle trade-offs: the societal perspective

The focus of this paper has been the individual perspective on choices of informal employment. We thereby have not so much treated the societal perspective, which is of course important from a development perspective. The results of our review offer important insights into how governments and donor agencies may have to change their policies and instruments to better deal with realities on the ground.

Three points seem to emerge: First, there is a need for a holistic assessment of the impact of informal employment on the economy. It is clear that for many reasons from an individual perspective it makes sense to stay informal – but from a societal perspective it is clearly not. To develop a conducive business environment and public services, a certain formalisation of an economy is needed. The critical question here is: how to do it?

Many examples show that an aggressive formalization often leads to the opposite result. It is a very important step forward to identify the right set of incentives through a critical review of good-practices.

Secondly, and following the same line of argument, the more general question is whether the existing policies and instruments of developing countries as well as of donor agencies do take into account the changing and heterogeneous realities on the ground. As an example, it is often not understood that the appropriate unit for risk management is not the individual, but the household or family. Often members of families are allocated strategically between formal and informal employment. This has important consequences for providing the right incentives for developing appropriate services to informal business as well as for setting-up social protection mechanisms for those in the informal sector.

Third, there is a need to differentiate between low-, middle- and high-income countries. In the low income context the formal sector's size is too small so that finding a job in the formal sector is for many not a realistic option. The critical challenge here is the transformation of a low labour productivity economy, mostly based on agriculture, to labour intensive manufacturing, and services. In middle income countries the challenges are quite different. Here there is a need to improve formal and informal linkages to create a conducive business environment and to allow for a better social protection of those currently not covered.

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