“Informality”: It’s Time to Stop Being Alice-in-Wonderland-ish

Gary S. Fields
Cornell University and IZA

This Version: February, 2011

> “When *I* use a word,” Humpty Dumpty said in rather a scornful tone, “it means just what I choose it to mean – neither more nor less.”
>
> “The question is,” said Alice, “whether you *can* make words mean so many different things.”
>
> “The question is,” said Humpty Dumpty, “which is to be master . . .that’s all.”
>
> Lewis Carroll,
> *Through the Looking Glass*

Introduction

“Informality” and its cousin concepts “informal sector,” “informal economy,” and “informal employment” are prominent in social scientific and policy discourse these days. Examples are the ILO’s extensive data base on Informal Economy (available at http://www.ilo.org/public/english/employment/infeco/), the World Bank’s 2007 flagship report *Informality*, the OECD’s ongoing project on Informal Employment Re-loaded (Jutting et al, 2008), among many others. The reason for the importance of projects like these comes from the fact that an estimated 93% of workers in a country like India and 72% of non-agricultural employment in sub-Saharan African is said to be in the informal economy. (In India, the term used is “unorganized.”) Considerable policy attention is being paid to ways of expanding employment in the better-jobs part of the economy, providing protections and increasing earnings for those in the poorer-jobs part of the economy, and increasing education and training for the least-skilled.

Quite remarkably and unaccustomedly for our profession, the widespread discussion about informality is proceeding without an agreed-upon definition of the term. Even more astonishingly, the field seems to have reached agreement that *informality means different things to different people.*

Consider the following statement from the first page of a major World Bank report entitled *Informality*:

> “The mere fact that we need to employ multiple measures of informality capturing distinct approaches to the sector suggests that we are not clear on exactly what it is and what we should be studying. In all likelihood, we are dealing with several distinct phenomena under this convenient, but arguably unhelpful, umbrella term.”
>
> World Bank (2007, p. 1)

But then the report goes on for 248 pages analyzing this “not clear” and “unhelpful” notion.

Moving from a study coming out of an international organization to one emerging from academia, a two-volume study (Guha-Khasnobis, Kanbur, and Ostrom, 2006; Guha-Khasnobis and Kanbur 2006) said this:

> "The usefulness of the formal-informal dichotomy has constantly been debated in the literature, which still does not provide any consistent definitions. Instead, it turns out that formal and informal are better thought of as metaphors that conjure up a mental picture of whatever the user has in mind at that time."
>
> Guha-Khasnobis, Kanbur, and Ostrom (2006, p. 4).

Nonetheless, these authors too felt the need to continue to use the term "informality." As Ravi Kanbur has put it, "Informality is a term that has the dubious distinction of combining maximum policy importance and political salience with minimal conceptual clarity and coherence in the analytical literature . . . The term is too well-entrenched for us to be able to drop it."

For a long time, I used to agree, but I no longer do. The voices urging change, which started as lonely murmurs (e.g., Peattie, 1987), are progressing from a chorus to a crescendo. It is important for understanding, but even more important for policy, to be clear what we are talking about when we use terms like "informality," "informal sector," "informal economy," and "informal employment." In the balance of this note, I explain my concerns and propose a remedy.

Antecedents

Twice before, I have been involved in literatures and policy discussions in which a vague concept was at first used extensively and later replaced by specific sub-concepts. One involved the term "income distribution" and the other the term "income mobility."

On "income distribution," Simon Kuznets delivered his famed Presidential address to the American Economic Association in 1954 (published shortly thereafter as Kuznets, 1955) on "Economic Growth and Income Inequality." He later published a series of papers on various aspects of the economic growth of nations, the best-known of which today is his article on "The Distribution of Income by Size" (Kuznets, 1963). Kuznets's Harvard colleague Hollis Chenery took up the challenge and, as Chief Economist of the World Bank, commissioned a series of studies, the most famous of which was the co-edited volume *Redistribution with Growth* (Chenery et al., 1974). Indeed, by the mid-1970s, income distribution had become central to the discourse on economic development.

For a time, the term "income distribution" meant (and means) different things to different people. Now, though, analysts for the most part use "income distribution" to mean the entire density or cumulative distribution function of income (or other economic entities such as consumption or labor earnings) and distinguish clearly between four different aspects of income distribution: inequality, poverty, income mobility, and economic well-being. On the other hand, this practice is not yet unanimous, and some of the leading lights in the profession, including Tony Atkinson and François Bourguignon, use the term "income distribution" as a synonym for "income inequality." This ambiguity of usage creates unnecessary confusion in the literature, which could be easily overcome if we were all to follow Kuznets's lead and write or speak about "income inequality" or whichever other aspect of income distribution we are studying.

A second concept on which there is considerable ambiguity of usage is "income mobility." Generically, income mobility is about the changes in income observed when the same individuals or households are followed over time. When I first started working on this topic in the 1990s, I would be presenting results on the meaning and measurement of mobility when someone in the audience would raise his or her hand and say, "But that's not what mobility *is!*" What I learned is that different people had different ideas of what income mobility is, and furthermore they had different *clear* ideas of what they had in mind. These ideas could be put into six categories: mobility as time-independence, positional movement, share movement, non-directional income movement, directional income movement, and mobility as an equalizer of longer-term incomes. The profession is still learning that the coefficient obtained from a regression of final income on initial income measures time-independence, the mean number of deciles moved measures positional movement, the mean absolute value of income change measures non-directional income movement, and that these are not alternate measures of the same concept but rather each is a measure of a different concept. For more on the many facets of "income mobility", see Fields (2006).

The Many Meanings of "Informality"

"Informality" has been used to mean many different things. Some of the definitions that have been used at various times in the past and are still being used today, with one citation for each, are:

- The enterprise registration definition (Guha-Khasnobis, Kanbur, and Ostrom, 2006): The enterprise is not registered with the government and is therefore beyond the reach of the state.
- The legality definition (DeSoto, 1986): The informal sector is that economic activity operating beyond the prevailing legal and institutional frameworks.
- The small enterprise definition (Sethuraman, 1981): Enterprises are informal if they employ fewer than five or ten employees, and the workers in those enterprises are by definition informal.
- The amplified small enterprise definition (Souza and Tokman, 1976): The informal sector is comprised of: the self-employed with less than thirteen years of education; unpaid family members, employees, and employers in establishments of less than ten employees; and domestic servants.
- The microentrepreneur definition (Maloney, 2004): The informal sector includes, among other things, the unregulated developing country analogue of the voluntary entrepreneurial small firm sector found in advanced countries.
- The survivalist definition (Tokman, 2001): "Informal sector activities are the result of pressure exerted by a labor surplus for jobs when good jobs, usually in the modern sectors, are scarce. The result is that the people seek low-productivity income solutions by producing or selling anything that may provide for their survival."

- The social protection definition (Levy, 2008): Formal workers are defined as paid employees working for a firm that registers them with the social security system, as a consequence of which workers are entitled to benefits, are covered by firing and severance pay regulations, and are obligated to pay labor taxes.
- The lack of separation definition (ILO, 1993): "[Informal enterprises] are private unincorporated enterprises (excluding quasi-corporations), i.e., enterprises owned by individuals or households that are not constituted as separate legal entities independently of their owners, and for which no complete accounts are available that would permit a financial separation of the production activities of the enterprise from the other activities of its owner(s)."
- The Brazilian definition (Merrick, 1976): A worker is formal if s/he is employed and possesses a signed labor card.

Other definitions are more comprehensive in nature:

- One of the earliest and most comprehensive definitions of informality is that contained in the ILO's Kenya report (ILO, 1972, p. 6). As they explained it: "Informal activities are the way of doing things, characterized by –
  (a) ease of entry;
  (b) reliance on indigenous resources;
  (c) family ownership of enterprises;
  (d) small scale of operation;
  (e) labour-intensive and adapted technology;
  (f) skills acquired outside the formal school system; and
  (g) unregulated and competitive markets. . .

  The characteristics of formal-sector activities are the obverses of these, namely –
  (a) difficult entry;
  (b) frequent reliance on overseas resources;
  (c) corporate ownership;
  (d) large scale of operation;
  (e) capital-intensive and often imported technology;
  (f) formally acquired skills, often expatriate; and
  (g) protected markets (through tariffs, quotas and trade licenses)."

  What is unclear from these definitions is whether all seven of these characteristics are required for an activity to be classified as formal or informal, whether an activity is to be classified as formal or informal on the basis of the preponderance of the seven characteristics, or whether informality is to be thought of as a continuum on a seven-point scale.

- The ILO (1993) defined the "informal sector" as the group of household enterprises or unincorporated enterprises owned by households that includes:
  - Informal own-account enterprises, which may employ contributing family workers and employees on an occasional basis; and

- Enterprises of informal employers, which employ one or more employees on a continuous basis.

- An even broader notion is that of the "informal economy." The WIEGO-ICLS-ILO definition of the informal economy (WIEGO: Women in Informal Employment: Globalizing and Organizing; ICLS: International Conference of Labor Statisticians; ILO: International Labor Organization) comprises informal employment of two kinds:

  (1) Self-employment in informal enterprises (small unregistered or unincorporated enterprises) including: employers, own account operators and unpaid family workers in informal enterprises; and

  (2) Paid employment in informal jobs (for informal enterprises, formal enterprises, households, or no fixed employer) including: casual or day laborers, industrial outworkers, unregistered or undeclared workers, contract workers and unprotected temporary and part-time workers.

  Source: ILO (2002).

Empirical studies show only a limited degree of overlap between those workers classified as informal according to the various definitions. A study of Brazil by Henley et al. (2008) used three alternative definitions: a) whether the worker has a signed labor card, b) whether the worker makes contributions to a social security institute in respect of employment, and c) whether the worker is employed in an establishment with more than five employees. The study finds that 64% of the economically active population in Brazil is informal according to at least one definition, but only 40% is informal according to all three. Along similar lines, Gasparini and Tornarolli (2007) looked at the degree of overlap between those classified as informal according to a productive definition and those classified as informal according to a legalistic definition. Out of fourteen Latin American countries studied, in *none* were more than half of the wage and salaried workers who were classified as informal by one definition also classified as informal by the other.

A Suggested Remedy

In both the income distribution and income mobility literatures, there was a straightforward remedy: to replace the generic concept by more precise ones. In the first case, the solution was to reserve the term "income distribution" for the entire density or cdf and to distinguish between the four logically distinct aspects of the income distribution mentioned earlier: inequality, poverty, mobility, and economic well-being. In the second case, the solution was to reserve the term "income mobility" for the generic idea of economic change for income recipients who are observed at two or more points in time and to distinguish the six logically distinct aspects of income mobility listed above: mobility as time-independence, positional movement, share movement, non-directional income movement, directional income movement, and mobility as an equalizer of longer-term incomes. Today, these literatures are not entirely free of confusion, but they are much less confused than they once were.

The remedy I would suggest for the “informality” literature is precisely the same: to replace the generic concept by more precise ones while discontinuing the use of the generic notion. The following are examples of what I am recommending.

A report by the Inter-American Development Bank used a number of alternative definitions of informal sector based on whether the worker receives the social security benefits mandated by labor laws, the worker’s category of employment, and firm size. The actual facts presented for Mexico in the report are these:

- 16% of the workers who started in a job without social security benefits moved within six months to a job with benefits.
- 16% of the workers who started with social security benefits moved within six months to a job without benefits.
- 23% of the self-employed became wage employees within six months.
- 5% of wage employees became self-employed within six months.
- 16% of workers employed in firms with fewer than five employees moved to larger firms within six months.
- 7% of workers employed in large firms and 25% of those employed in medium-size firms moved to small firms within six months.

What we learn by stating findings in these ways is what the actual facts are, which itself is progress. The diverse nomenclature has blurred the discussion rather than enlightening it.

As another example, an ILO study (Kucera and Roncolato, 2008) presents data on “the share of informal employment” (their term, p. 326) in different regions of the world. The authors say that they “approximate” informal employment by the sum of self-employed and unpaid family workers in urban and rural areas (pp. 326-7). Only after presenting these data do the authors inform their readers of the fact that the ILO’s definition of informal employment “adds to employment in informal establishments (that is, employment in the informal sector) informal employment in formal establishments” (p. 328). The empirical measure used by the authors is a very crude approximation of the ILO’s definition of informal employment. Nonetheless, the data presented are informative: the reader can see clearly that the shares of self-employed and unpaid family workers are much higher in South Asia and sub-Saharan Africa than in East Southeast Asia and Latin America, and that these are much higher still than in the developed countries. In my view, equating self-employed plus unpaid family workers to informal employment adds nothing and in fact hampers understanding.

Implications for Labor Market Segmentation and Sector Choice

What do such facts imply about labor market segmentation and the voluntariness of working in jobs without benefits? The usual definition of a segmented labor market is that 1) For any given class of worker, some jobs are better than others, and 2) Access to the better jobs is limited in the sense that not all who want the better jobs and who are qualified to perform them are able to obtain them. The IADB report from which the bulleted points above are taken states (p. 69), “Regardless of the definition of informal workers considered, the evidence does *not* support the segmentation approach.”

When labor market segmentation is defined in this way, the preceding facts enable *no conclusion whatsoever* to be reached about whether the labor market is or is not segmented. In other words, *no* inference can be drawn from the preceding data about whether Mexicans are working in jobs without social security benefits because they choose to or because they have no choice – either inference is an interpretation, not a scientifically-established fact. More direct evidence can and should be gathered.

Implications for Policy

Robert Holzmann, until recentlyh the head of the Social Protection unit at the World Bank, has said: “There is a wide agreement on the fact that a large informal economy leaves many individuals without social protection and reduces government’s tax revenue and social security contributions. However, it remains an open question what really drives informality, namely whether workers are simply trapped out of the formal sector or, at least some of them, chose it because it offers better alternatives than a formal job. The policy implications are clearly different in the two cases.”

Holzmann’s own principal concern is working without social protection. Given this concern, some facts such as “23% of the self-employed became wage employees within six months” and “16% of workers employed in firms with fewer than five employees moved to larger firms within six months” are simply uninformative to our understanding of why the majority of workers in developing countries are in jobs without social protection and how social protection can be improved for them.

On the other hand, facts such as “16% of the workers who started with benefits moved within six months to a job without benefits” are clearly relevant but at the same time incomplete. Such facts *give no indication at all* about whether the workers who started in jobs with social security benefits could have remained in those jobs or, alternatively, whether the jobs were of limited duration, the workers were laid off or fired for cause, or the firm went out of business. The design of better policies requires more knowledge about why what we observe is observed.

Conclusion

This note has offered both a critique and a remedy. The critique is that because the terms “informality,” “informal sector,” and “informal economy” mean different things to different people, the use of these terms impedes rather than enhances communication. The remedy proposed is straightforward: to say what we mean explicitly without ever using the word “informal,” as was done in the “Suggested Remedy” section above. Social scientific and policy discourses would be strengthened if the profession were to follow this precept.

By stating our knowledge in terms of what in fact we know instead of using code words like “informality,” “informal sector,” and “informal economy,” not only will we understand better the nature of the problem but we may in some cases come to see better which policies would make the most difference. For the more than three billion people in the world who live on less than two-and-a-half U.S. dollars per person per day, the design of better policies can come none too soon.

References

Chenery, Hollis et al., eds., *Redistribution with Growth.* (New York: Oxford University Press, 1974).

DeSoto, Hernando, *El Otro Sendero: La Revolución Informal.* (Lima, Peru: Instituto Libertad y Democracia, 1986).

Fields, Gary S., "The Many Facets of Economic Mobility," in Mark McGillivary, ed., *Inequality, Poverty and Well-Being* (Houndsmills, Basingstoke, Hampshire: Palgrave Macmillan, 2006).

Gasparini, Leonardo and Leopoldo Tornarolli, "Labor Informality in Latin America and the Caribbean: Patterns and Trends from Household Survey Microdata," CEDLAS Documento de Trabajo No. 46, February, 2007.

Guha-Khasnobis, Basudeb and Ravi Kanbur, eds, *Informal Labor Markets and Development.* (New York: Palgrave Macmillan, 2006).

Guha-Khasnobis, Basudeb, Ravi Kanbur, and Elinor Ostrom, eds., *Linking the Formal and Informal Economy: Concepts and Policies.* (Oxford: Oxford University Press, 2006).

Henley, Andrew, G. Reza Arabsheibani, and Francisco G. Carneiro, "On Defining and Measuring the Informal Sector: Evidence from Brazil," Paper presented at the IZA-World Bank Conference on Employment and Development, Rabat, Morocco, May, 2008.

Inter-American Development Bank, *Good Jobs Wanted.* (Washington: Inter-American Development Bank, 2003).

International Labour Organisation, *Employment, Incomes and Equallity: A Strategy for Increasing Productive Employment in Kenya.* (Geneva: ILO, 1972).

International Labour Organisation, *ILO Report of the Fifteenth International Conference of Labour Statisticians.* (Geneva: ILO, 1993).

International Labour Organisation, *Women and Men in the Informal Economy: A Statistical Picture.* (Geneva: ILO, 2002).

Jütting, Johannes, Jante Parlevliet, and Theodora Xenogiani, "Informal Employment Reloaded," OECD Development Centre Working Paper No. 266, January, 2008.

Kucera, David and Leanne Roncolato, "Informal Employment: Two Contested Policy Issues," *International Labour Review*, 2008, 321-348.

Kuznets, Simon, “Economic Growth and Income Inequality.” *American Economic Review*, March, 1955, 1-28.

Kuznets, Simon, “Quantitative Aspects of the Economic Growth of Nations: VIII, Distribution of Income by Size,” *Economic Development and Cultural Change,* January, 1963, Part 2, 1-80.

Levy, Santiago, *Good Intentions, Bad Outcomes.* (Washington: Brookings Institution, 2008).

Maloney, William F., “Informality Revisited.” *World Development*, 2004, 1159-1178.

Merrick, Thomas, “Employment and Earnings in the Informal Sector in Brazil: the Case of Belo Horizonte,” *Journal of Developing Areas*, 1976, 337-353.

Peattie, Lisa, “An Idea in Good Currency and How It Grew: The Informal Sector,” *World Development*, 1987, 851-860.

Sethuraman, S.V., ed., *The Urban Informal Sector in Developing Countries: Employment, Poverty, and Environment.* (Geneva: ILO, 1981).

Souza, Paulo R. and Victor E. Tokman, “The Urban Informal Sector in Latin America.” *International Labour Review,* 1976, 355-365.

Tokman, Victor E., “Integrating the Informal Sector into the Modernization Process,” *SAIS Review,* 2001, 45-60.

World Bank, *Informality: Exit and Exclusion,* (Washington: World Bank, 2007).