

Policy Note

Revisiting Informality in South Asia: An Agenda for the Future Social Protection and Jobs

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Introduction

More than 80 percent of labor force in South Asia is in the informal sector where people or firms tends to stay in the informal sector because of economic subsistence and cost saving. In Bangladesh, India, Nepal, and Pakistan, the informal sector accounts for more than 80 percent of the economic activity. Some of the factors that increase the probability of employment in the informal sector are low levels of education, work in urban areas, young age, and poverty. On one hand, informality can be an economic subsistence strategy where people engage in informal work for survival reasons, in the absence of better-quality jobs. While, on the other hand, it can help save costs associated with taxes and other regulatory requirements.

The level of informality has been persistently high in South Asia despite high growth rates. Informality is often associated with low economic growth but the regional GDP growth rate in South Asia has remained between 5 and 7.5 percent from 2010 and 2019 while informality has either remained constant or increased in some cases.

This note presents three stylized facts about informal economy in South Asia, which can be relevant for labor market programs and policies:

- 1) *All poor are informal but not all informal are poor*: More than 80 percent of wage workers in the poorest wealth quintile in Bangladesh and Nepal are in the informal sector as compared to around 50 percent in the top quintile. Though informality remain dominant, there are significant differences in informal

workers across wealth quintiles. For example, informally employed in bottom 40 percent are less educated and mostly in the agriculture sector as compared to their counterparts in the top 60 percent of wealth distribution. This also translates into type and quality of jobs where those in top 60 tend to have better quality higher paying jobs.

- 2) *Informal jobs pay less than the formal jobs across all wealth quintiles:* A comparison between formal and informal workers within every quintile shows that informal workers earn less than the formal sector workers and these differences get significantly larger in upper quintiles. A part of it can be explained based on the profile of informal workers: even within the same quintile, informal workers are, on average, less educated than their formal sector counterparts, which is a key determinant of earnings.
- 3) *Informal workers lack social protection coverage and are vulnerable to shocks:* Informal workers lack access to labor protections including social protection, which makes them vulnerable to impacts of both idiosyncratic and covariate shocks. Social insurance coverage remains very low Sri Lanka at 7.8 percent has the highest coverage of social insurance in the region. Moreover, households, especially those in the bottom quintiles, are less likely to have any savings.

In this context, programs and policies addressing the vulnerabilities of the informal workers must (i) target those in the bottom quintiles as they not only earn less but are also more vulnerable to impact of shocks; (ii) expand the coverage of social protection and labor markets programs to ensure those who are not covered by social assistance programs have access to other safety nets; and (iii) select instruments that cater to specific needs of the population given the significant variation in wealth and human capital accumulation.

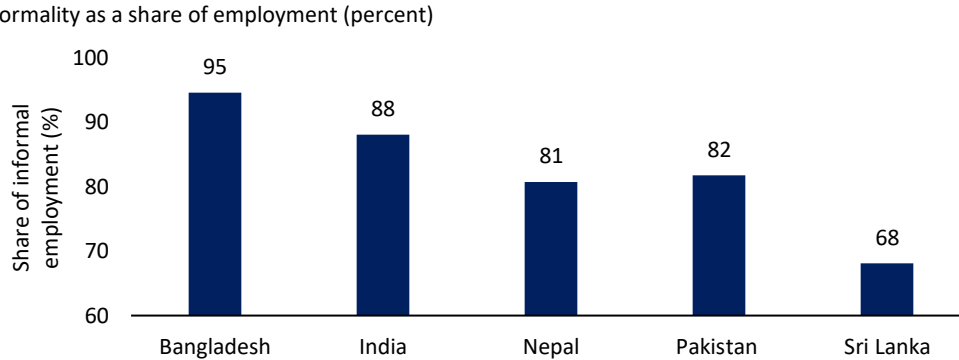
Informality is ubiquitous but not a monolith

The majority of the workforce in South Asian countries is employed in the informal sector. The ILO defines the informal economy as all economic activities by workers and economic units (e.g., firms) that are *de jure* or *de facto* not covered or insufficiently covered by formal arrangements.¹ This is an inclusive definition, and can cover a range of different circumstances, covering the perspectives of both workers and firms. From the perspectives of a worker, informality may mean not having identification for tax purposes, pensions or social insurance coverage, or even a formal contract with the employer. From the perspectives of an employer, informality may mean not being registered with the government. In some cases, informality as a status may arise even with partial coverage, as in the example of a firm which may be registered and paying taxes, but which may have

¹ The criteria used are based on employment status, institutional sector, destination of production, bookkeeping, registration, social security contribution, places of work and size.

employees without formal contracts. In Bangladesh, India, Nepal, and Pakistan, the informal sector accounts for more than 80 percent. Sri Lanka is an exception in the region with only 68 percent of employment in the informal sector (Figure 1).

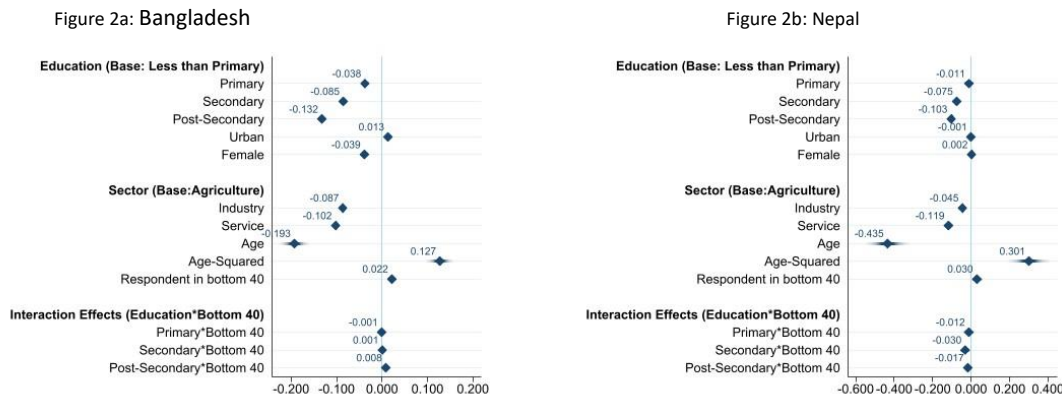
Figure 1: Share of informal sector workers across countries in South Asia



Source: Data from LABORSTA

Workers with low levels of education and wealth are more likely to be in the informal sector. Country regression analyses in Bangladesh and Nepal suggest that the following characteristics increase the probability of having an unpaid or informal job: i) young, ii) urban, iii) agriculture sector, iv) low levels of education, and v) low levels of wealth (Figure 2a and 2b, and Annex 2). For example, in Bangladesh, workers with post-secondary education are less likely to be in informal or unpaid jobs as compared to those with no education. Similarly, working in the services sector decreases the probability of informal or unpaid work as compared to the services sector. In contrast, workers living in urban areas and those with low levels of wealth are more likely to be in the informal sector.

Figure 2: Impact of select variables on probability of being informally wage-employed versus formally wage-employed (probit regressions)



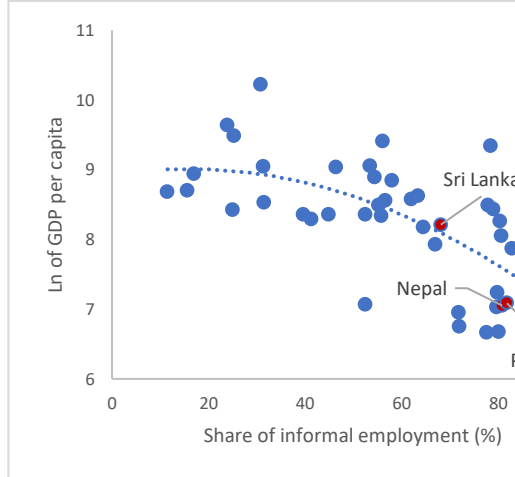
Note: Data from Labor Force Survey (LFS) of Bangladesh (2016) and Nepal (2018). All coefficients are statistically significant.

There are two main reasons for why people or firms may be in the informal economy: economic subsistence and cost saving. The first perspective considers informality to be an economic subsistence strategy, with people engaging in the informal sector for survival reasons, which could be because of absence of better-quality jobs (Lewis 1954, Fields 1975). The second perspective frames informality as a choice taken by economic agents – either firms or people – to minimize costs, by avoiding costs incurred by taxes or regulatory requirements such as minimum wage or labor protection legislation (Chaudhuri and Mukhopadhyay 2010; Maloney 2004). Given the breadth of the informal sector in most economies, the reason for informality is often a combination of the two reasons. That is, some actors that are in it for economic subsistence while others doing so for minimizing cost accounting for factors like changing labor costs or capital accumulation. This has been documented in Mexico (Cunningham and Maloney 2001), Côte d'Ivoire (Gunther and Launov 2012), and Ecuador (Canales 2020). More recently, Ulysea (2020) argues that informality is an endogenous outcome that emerges as the result of economic actors optimizing their objective function given their characteristics (e.g., ability), their institutional context, and the external economic environment.

Irrespective of the cause, informality is a major developmental issue because it is often associated with low economic growth, but this trend is not observed in South Asian economies. Economies with higher rates of informality mostly have lower per capita incomes (Figure 3). Such economies also tend to have a private sector with low level of access to finance, low labor productivity, slow physical and human capital accumulation, and small fiscal resources (Ohnsorge and Yu 2021). However, while the regional GDP growth rate remained between 5 and 7.5 percent from 2010 to 2019, there has been a little change in level of informality in South Asian countries (Figure 4). On the contrary, in Bangladesh and Pakistan, the level of informality increased whereas in India, it has remained constant (figure 4). It is also significantly higher as compared to other emerging economies such as Argentina, Brazil, and Mexico. There is no evidence of correlation between long term GDP growth and reduction in informality (OECD and ILO 2019). Moreover, even with high growth rates, South Asian economies have not been able to produce jobs: between 2000 and 2020, around 386 million South Asians entered the working age population, whereas only 81 million jobs were added to the economy (Alaref et al 2023). This suggests that the South Asian economies are not able to turn their growth rates into job creation whereby missing productivity opportunity.

Figure 3: Poor countries have a higher share of informal employment than less-poor countries

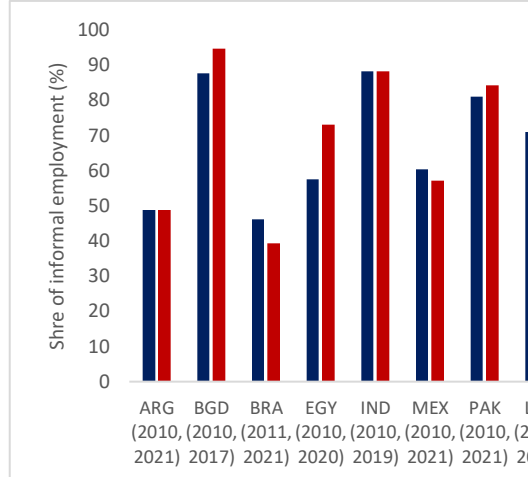
Informality as share of employment (percent) (x-axis) and income (Ln of GDP per capita current USD) (y-axis)



Source: Authors' estimates based on data from LABORSTA and World Development Indicators (WDI) 2021

Figure 4: Informality rates have changed little over time

Informality rates, select emerging market economies for earliest and latest years with data (percent)



Source: Ahmed, Cunningham, and Santos (2022) based on data from LABORSTA

Note: ARG = Argentina, BGD = Bangladesh, BRA = Brazil, EGY = Egypt, IND = India, MEX = Mexico, PAK = Pakistan, LKA = Sri Lanka, VNM = Vietnam

Informal workers also lack protections and generally work in poor conditions, increasing their vulnerability to various shocks. Jobs in the informal sector are characterized by lack of labor contracts and access to social protection, underscoring the vulnerability of informal workers. Due to the “informal” nature of their work, it is also hard to enforce labor regulations or minimum standards of decent work. All South Asian countries have minimum wage laws, but they are seldom enforced, and workers often earn significantly less than the stipulated minimum wage.

This note presents three stylized facts about the informal economy in South Asia relevant for labor market policies and programs in the region. First, all poor are informal but not all informal are poor: while informality is ubiquitous in South Asian countries, there is a significant heterogeneity within the informal sector especially across wealth quintiles. Informal workers in the bottom 40 percent of distribution tend to have low levels of education and are mostly concentrated in agriculture sector as compared to the top 60 percent. Second, informal sector is characterized by low paying and low productivity jobs where informal sector workers earn less than their formal sector counterparts across all wealth quintiles. Third, by virtue of being outside certain legal and institutional coverage, the informal sector workers (particularly the poor) are also more vulnerable to covariate and idiosyncratic shocks. In the context where South Asian countries are highly exposed

to climatic shocks and low levels of savings among the population, this can have catastrophic impacts.

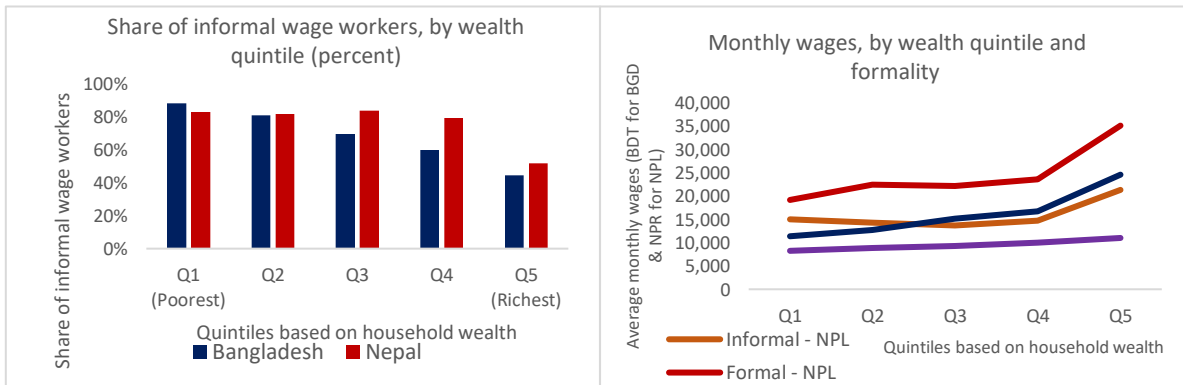
It is beyond the scope of this note to identify reasons why firms and individuals remain in the informal sector or to discuss policies related to formalization of firms. Since policies focused on regulatory enforcement to induce formalization of firms, by and large, have not been successful, this note tries to highlight vulnerabilities and constraints of informal workers by shifting the focus from formalization to access to good quality jobs. The remainder of this note is organized as follows. Section 2 presents the three stylized facts and their implications (Annex 1 has detailed on data and methodology). Section 3 concludes and proposes programs and policies.

Three stylized facts about the poor and informality

Stylized Fact 1: All poor are informal but not all informal are poor

The poor are more likely to be in the informal sector and earn less than the non-poor informal workers. In both Nepal and Bangladesh, more than 80 percent of wage workers in the poorest wealth quintile are in the informal sector. While the share of informal workers decreases in the higher quintiles, it remains the dominant sector where around 50 percent of wage workers in the top quintile are still in the informal sector. The Labor Force Survey (LFS) data from Bangladesh and Nepal illustrate the incidence of informal wage jobs across wealth quintiles (Figure 5).² There is also a significant difference between earnings of informal workers in the top and bottom: in both Nepal and Bangladesh, informal workers in the bottom quintile earn significantly less than their formal sector counterparts.

Figure 5: Informality is more prevalent among poorer households, and informal workers consistently earn less than formal workers within the same quintile.

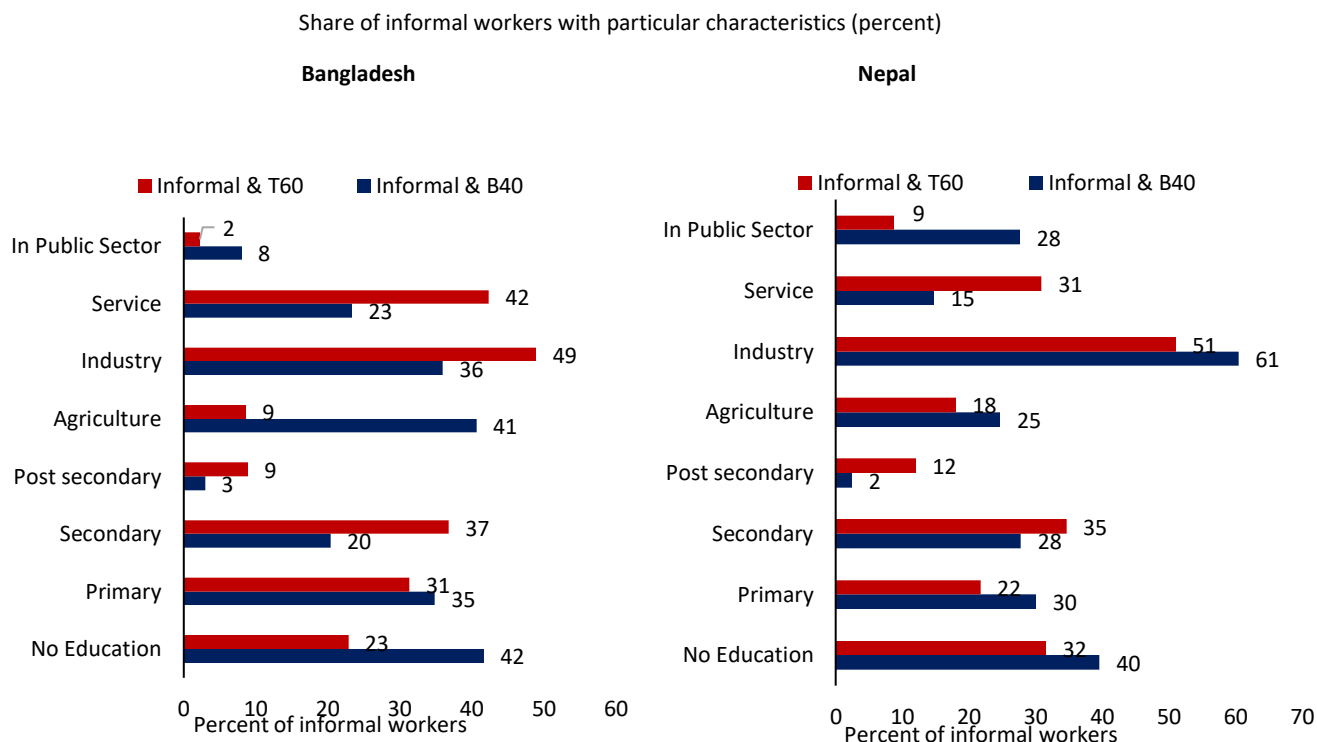


Source: Based on Labor Force Survey (LFS) data for Bangladesh (2016) and Nepal (2018); Note: BGD = Bangladesh, NPL = Nepal

² An informally employed person in these specific examples is defined as someone working without a formal contract.

Within informal sector, there is also a significant heterogeneity across wealth quintiles in types of jobs as well as the profile of workers. Informal wage employment in many countries is tilted mostly towards low-skilled industries, such as construction and agriculture where agricultural activities are much more common in the bottom 40 (B40) percent as compared to the top 60 (T60) percent. Non-agricultural activities in the informal sector mostly comprises of wholesale and retail trade services (Alaref et al 2023). But it can take different forms ranging between from home-based work and street vending to activities in the gig economy. These differences could be a function of educational background: informally employed in the B40 tend to be less educated and mostly in agriculture as compared to the informal workers in T60 (Figure 6). Also, a smaller proportion of the B40 is in the public sector than the T60.

Figure 6: Informally employed wage workers from B40 households tend to be less educated and working mostly in agriculture, compared to informally employed wage workers from T60 households



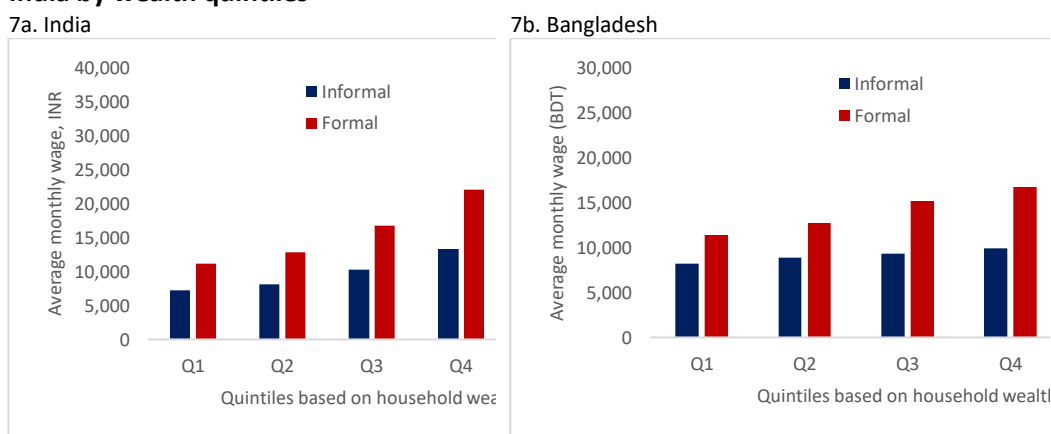
Note: All differences between B40 and T60 informally employed wage workers are statistically significant. Based on Labor Force Survey (LFS) data for Bangladesh (2016) and Nepal (2018).

Stylized Fact 2: Informal jobs pay less than formal jobs across all wealth quintiles

A comparison between formal and informal workers within the same quintiles shows that informal workers, on average, earn less than their formal counterparts. There are

significant differences in wages of formal and informal workers across all wealth quintiles. For illustration purposes, Figures 7a and 7b show average wages of formal and informal workers in India and Bangladesh across all wealth quintiles. In India, informal workers earn INR 60 to 65 for each INR 100 earned by formal workers whereas in Bangladesh it is Tk 45 to 72 for each Tk 100. The difference between the earnings of formal and informal gets much wider in upper quintiles of distribution. Fig 7b shows that in the poorest quintile, an informal worker earns 73 percent of what a formal worker earns. This difference reduces to 45 percent in the top quintile.

Figure 7: Average monthly wage of informal and formal workers in Bangladesh and India by wealth quintiles



Source: Authors' calculations based on Labor Force Surveys from Bangladesh (2016) and India (2018).

Informal workers in the bottom quintile of the wealth distribution are different from the formal workers within the same quintile. Informal wage workers tend to be less educated and predominantly employed in the agriculture sector as compared to the formal workers in the poorest quintile (Figure 8). In contrast, formal sector workers in the poorest quintile, who have higher educational attainment, are also mostly in the public sector. Public sector jobs tend to be highly coveted due to better wages, job security, and benefits (such as formal pensions).

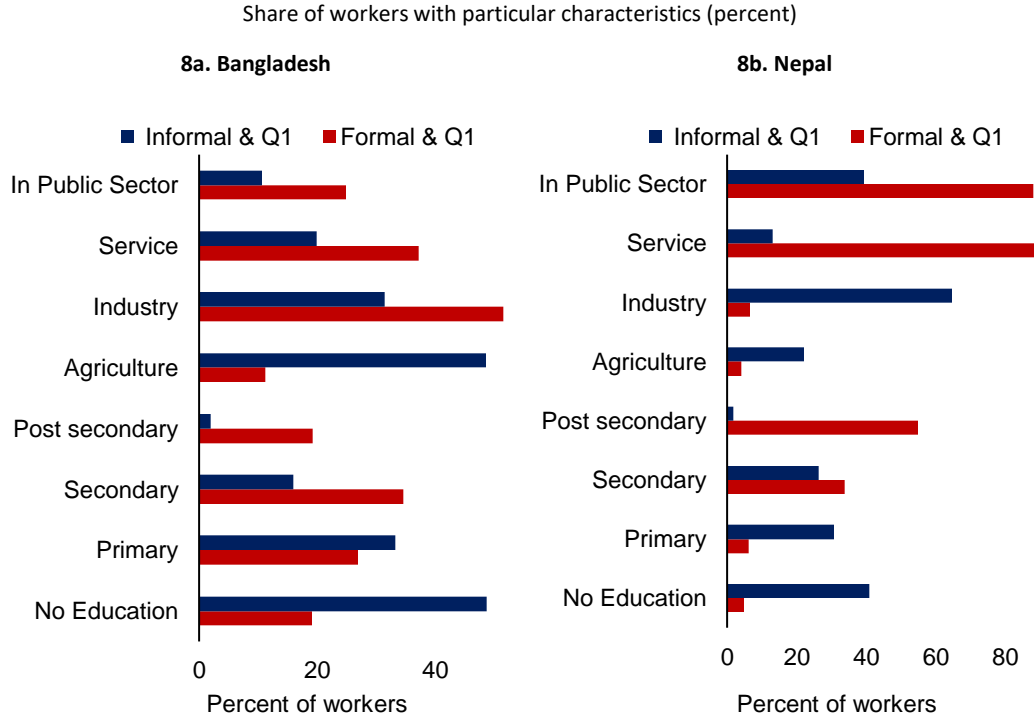
Even in Pakistan, where wealth distributional analysis is not possible due to data limitations, informal wage workers tend to be poorer and are noticeably different than the formal wage workers in other characteristics as well.³ For example, 63 percent of informal wage workers in Pakistan have monthly wages below the minimum wage of PKR 15,000⁴ as opposed to the 14 percent of formal wage workers. In case of education, 47 percent of informal wage workers have no education versus only 13 percent of formal wage workers. At the other end of the educational attainment spectrum, only 6 percent

³ Based on estimates using Pakistan's LFS 2017.

⁴ In the Federal Budget of 2021, minimum wage was increased to PKR 20,000

of informal wage workers have completed tertiary education compared to 38 percent of formal wage workers.

Figure 8: In the poorest households by wealth, informally employed workers tend to be less educated and mostly in rural agriculture, compared to formally employed workers.



Note: All differences between informal and formal wageworkers are statistically significant. Source: Authors' estimates based on Labor Force Survey (LFS) data for Bangladesh (2016) and Nepal (2018).

Educational attainment – among other characteristics – is a critical correlate of earnings, as illustrated by Mincerian regressions for Bangladesh, Nepal, and Pakistan (Figure 9). Mincerian regressions are based on the Mincer earnings function, which is a single equation model that predicts wage income as a function of education and experience. Country-level regressions show that the return on education is quite high in Bangladesh, Bhutan, Nepal, and Pakistan. For example, in Pakistan, workers with post-secondary education are likely to earn 79 percent more than those with no education. Working in urban areas and sectors such as industry and services, compared to agriculture, are also associated with higher earnings. Work experience, as proxied by age, is also statistically significant: one additional year of experience is associated with 8 percent increase in wages in Pakistan, 4 percent increase in Nepal, 6 percent in Bhutan, and 2 percent in Bangladesh. However, these patterns are not unique to South Asian economies and have also been observed in other developing economies. Tran et al. (2020) finds that education – after controlling for other variables – had a positive impact on household incomes in Vietnam. However, the paper also found that the wealthier households consistently had higher returns to education than poorer households, which could have impact on the overall income inequality. Similarly, Mincerian regressions for households in rural China

found that the returns on education were higher for better off households (Wei et al. 2006).

It can also be seen that informality, poverty (i.e., coming from a B40 household), and female gender incur penalties on earnings. Working in the informal sector reduces workers' earnings by 22 percent in Pakistan, 27 percent in Nepal, and 23 percent in Bangladesh. In addition, the gender wage gap between men and women is very high, even after controlling for labor market characteristics, estimated at 131 percent in Pakistan in favor of men, 39 percent in Nepal, and around 15 percent in Bhutan and Bangladesh. The penalty on earnings for being female has been well documented in South Asia, as illustrated by Ahmed and Rahman (2019), Rahman and Al-Hasan (2019), and Solatoroff et al. (2019) for Bangladesh, and Amir et al. (2018) and Ashraf et al. (1993) for Pakistan.⁵ Finally, workers in Pakistan and Bhutan who come from the poorest two quintiles are more likely to earn significantly less than those in the upper quintiles. Finally, the results show that more hours worked do not necessarily translate into higher wages, underscoring the low-equilibrium productivity trap that many workers are in.

The variables that are correlated with lower earnings are also found to be associated with the probability of being in the informal sector. This suggests that addressing basic supply-side issues like education, work experience, and social norms (especially around gender) could help poor informal wagedworkers to boost their incomes and perhaps to also enter the formal sector. For both Bangladesh and Nepal, being in the B40 of the wealth distribution and being female increased the probability of being informally employed, with coefficients being statistically significant (Figure 9). Moreover, having any education, being in manufacturing or services sector, or having more work experience reduced the probability of being informally wage-employed (as opposed to formally wage-employed).

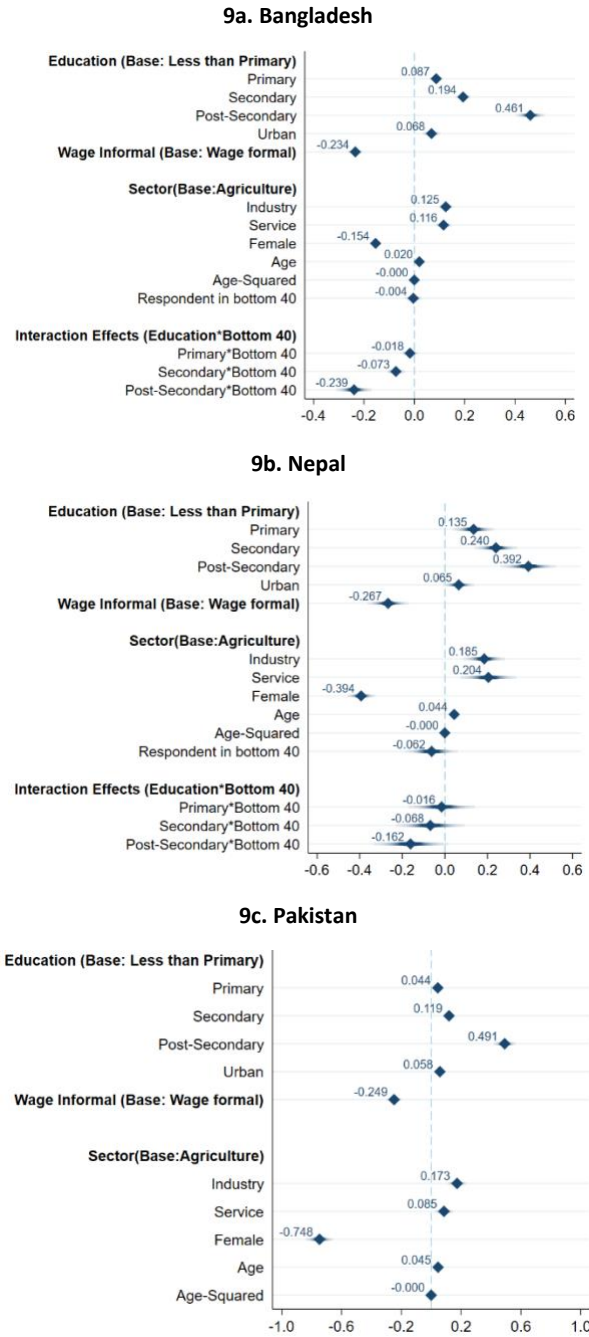
Stylized Fact 3: Informal workers lack social protection coverage and are vulnerable to shocks

People and households involved in the Informal sector are primarily vulnerable to shocks because of their lower income, as seen in the earlier section, but also face a range of shocks. Populations in South Asia tend to be highly exposed to a range of different shocks, both covariate and idiosyncratic. Two well documented shocks to which large segments of the population in South Asia are exposed to are climate hazards, and catastrophic health expenditures, related to the high out-of-pocket expenditures in the region. More than 40 percent of populations in South Asian economies are exposed to climate hazards – a figure which rise to 58 percent in the case of Bangladesh (Figure 10). When considering health shocks, with the exception of Bhutan, most countries in South Asia have large shares of their population at risk of catastrophic health expenditures (Figure 11). When

⁵ Conservative gender norms may restrict women's physical mobility and impose differing social practices in relation to the observance of various veiling practices, hindering female labor force participation (Ahmed and Sen 2018).

considering shares of population that are at risk of impoverishing expenditures on surgical care, rates of population at risk are similar for most countries, or even higher in the case of some, like Nepal and Bhutan.

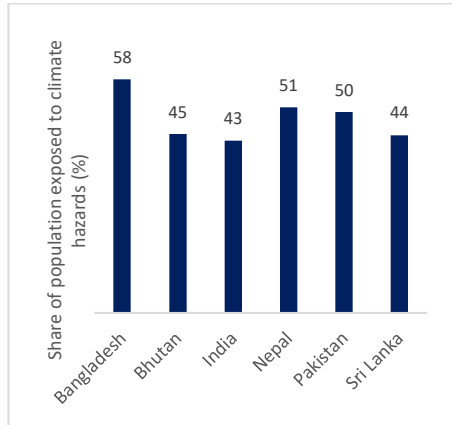
Figure 9: Association between select variables and monthly wages for Bangladesh, Nepal, and Pakistan (Mincerian regressions)



Note: Data from Labor Force Surveys (LFS) from Bangladesh (2016), Nepal (2018), and Pakistan (2017). All coefficients are statistically significant.

Figure 10: South Asia economies are highly exposed to climate hazards

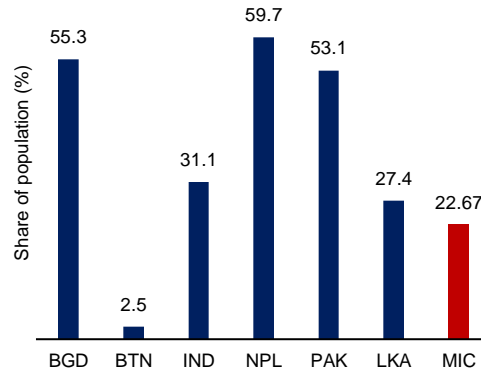
Population exposed to climate hazards (percent of population)



Source: Data from Amarnath et al. 2017

Figure 11: Most countries in South Asia have large populations at risk of catastrophic health expenditures

Share of population at risk of catastrophic health expenditures (percent)

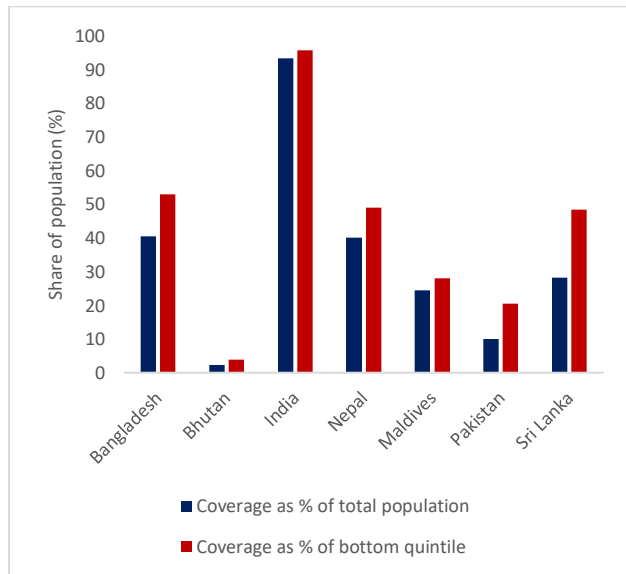


Source: Data from World Development Indicators 2021. A health expenditure is considered if it is more than 10 percent of a patient's overall income.
 Note: BGD = Bangladesh, BTN = Bhutan, IND = India, PAK = Pakistan, LKA = Sri Lanka, MIC = Middle-Income Countries

By virtue of being in the informal economy, members of the informal economy often lack access to protections and benefits to deal with these shocks. Few households South Asian economies have access to social insurance or other instruments to manage risk. The highest coverage of social insurance is in Sri Lanka, with 7.8 percent of the population covered by social insurance, and with rates much lower among lower income households. Social safety nets (SSN) – which could provide critical consumption support in times of crisis – have large coverage gaps that leave large segments of the labor market unprotected (Figure 12). For example, Pakistan and Bangladesh have coverage rates of 10 and 40 percent of total population, respectively. Both countries have means tested programs, reflecting a policy decision to focus safety net spending on lower-income households that are either poor, or vulnerable to impoverishment. However, program coverage in Bangladesh and Pakistan is determined by a combination of welfare or categorical selection criteria, as well as budget allocations by program. There are substantial coverage gaps remain including among the poor in urban areas, and the near-poor and those vulnerable to shocks (Figure 13). Less than 50 percent of the poor in South Asia receive social assistance. In the absence of access to insurance mechanisms, households must rely on their savings for risk mitigation, but even then, less than half of households among the bottom 40 of the consumption have any savings at all (Figure 14).

Figure 12: Social assistance coverage is limited for large segments of the population in many countries

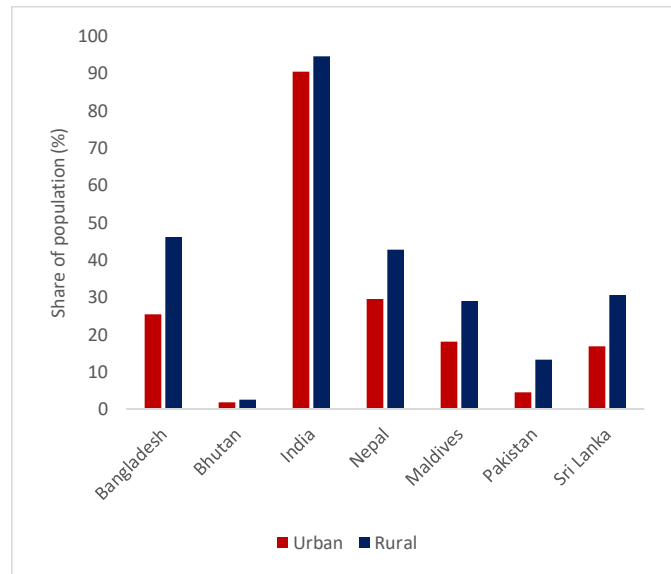
Social assistance coverage rates in SAR (percent)



Source: Data from ASPIRE (latest year available)

Figure 13: There are stark differences in safety net coverage between urban and rural areas

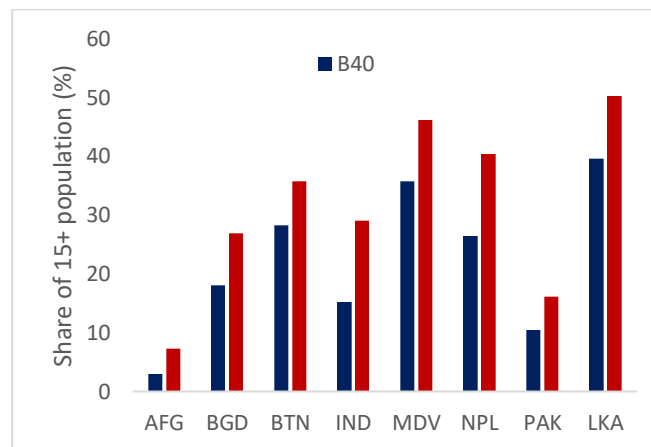
Social assistance coverage rates: urban vs. rural (percent)



Source: Data from ASPIRE (latest year available)

Figure 14: Lower-income households often do not have any savings

Share of households that have saved any money (percent)



Source: FINDEX, latest year available between 2014 and 2021.
 Note: B40 = bottom 40 of consumption distribution; T60 = top 60 of consumption distribution. AFG = Afghanistan, BGD = Bangladesh, BTN = Bhutan, IND = India, MDV = Maldives, NPL = Nepal, Pakistan = Pakistan, LKA = Sri Lanka

These vulnerabilities of the informal economy were brought to the fore during the COVID-19 pandemic. Simulations for Bangladesh, India, and Nepal show that informal workers

are over-represented among those likely to face job losses, especially in urban areas (World Bank 2020). While informal employment is 74 percent in urban India, the share among those newly unemployed by the shock is 83 percent. The unemployment shock affects informal workers across the full range of the earnings distribution, but the negative slope of the incidence curves indicates that workers most affected were located, before the job loss, at the low or middle percentiles of the distribution. Urban informal workers are particularly vulnerable because of their sectors of employment.

Policies and program need clarity on objective, scope, and scale

Based on the characteristics of the informal sector in South Asia described in earlier sections, four principles need to be considered before engaging in discussions of specific policies and programs to address informality from the perspective of a social protection and jobs agenda.

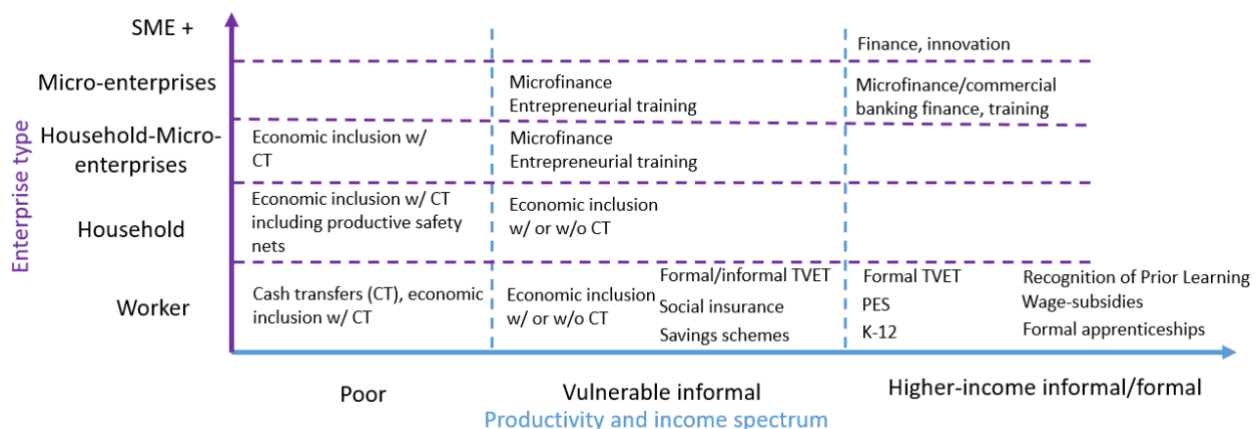
First, the policy objective must be clear, and focused on supporting the poor and vulnerable of the informal sector. Informality is ubiquitous in the region, and the reasons for being informal vary. From a social protection and jobs perspective, emphasis should be on providing services to the poor and vulnerable to boost productivity, and to manage and mitigate their risks. The incidence along the income distribution matters. As seen for Bangladesh and Nepal, there is a sizable presence of informal workers at every level of the distribution of earnings among South Asian workers. While informal workers do earn less than formal workers on average, there is also a significant variation in their income levels. Informal workers dominate the lower half of the income distribution, but they are also found in large numbers in the upper half of the earnings distribution and are present even at its top end. Program and policy focus should thus consider the high vulnerability of the lower-income segments of the informal economy, which would tend to include casual and temporary wage workers, as well as urban wage workers and the self-employed.

Second, expanding coverage of social protection and labor market programs, and having more integrated systems, could *de facto*, provide support to the informal sector poor and vulnerable. For example, expanding safety net coverage – whether through cash transfers, public works, or other instruments may be sufficient to protect some of these workers if the programs are means tested or poverty targeted. At the same time, many informal workers may not qualify for poverty-targeted programs due to the current eligibility criteria. In those cases, there may be a need to relax the conditions for eligibility, or have shock responsive systems that can scale-out (to include new beneficiaries), in addition to scaling up. Infrastructure like the National Socio-Economic Registry in Pakistan has been critical in expanding support to different labor market segments over numerous shocks. Similarly, integrated administrative systems allowed India to mobilize federal

funding through the umbrella Prime Minister’s Garib Kalyan Yojana (PMGKY) to a range of safety net, labor, and financial programs at the state level in response to the pandemic.

Third, different instruments need to be considered for different segments of the consumption/wealth/human capital continuum, as well as different economic units. Instruments can vary across the economic unit, and range from targeting the individual, household, and various sizes of firms, as illustrated by Figure 15. At the same time, the instrument may also depend on where the economic unit lies on the income distribution. In the case of South Asian economies, most employment is in micro-enterprises (including household enterprises and own account workers). For example, in the case of Bangladesh, 58.6 percent of wage workers are in micro-enterprises, and another 22 percent are in small and medium sized enterprises, based on LFS data. Within micro-enterprises, 86 percent of wage workers are in the informal sector. It is thus critical to account for not just workers and households, but also different types of enterprises. For the poorest segments of the labor market (who almost all are likely informal), a starting point for interventions would be safety nets, through expansion of coverage and improvements in adequacy at the individual and household levels (Figure 16). For segments that are vulnerable (but not poor) and informal, instruments at the individual level could be instruments like social insurance and saving schemes to boost the ability to manage risks. At the household and enterprise level they could be access to finance or economic inclusion programs with or without cash transfers, or even financial products like microfinance. With these perspectives in mind, there are already several World Bank Group projects that support the informal sector through these types of interventions (Table 1).

Figure 15: Framework on continuum of interventions based on economic unit, productivity, and formality status



Source: Authors’ elaboration based on Ahmed, Cunningham, and Santos (2022)

Table 1: Illustrative list of World Bank projects supporting informal sector through different instruments and economic units

World Bank Project	Relevance for support to informal sector
Bangladesh Recovery and Advancement of Informal Sector Employment	Targeting urban informal microenterprises and low-income urban youth; economic inclusion programs with micro-finance and informal apprenticeships
Cameroon Cash Transfer and Productive Inclusion Project	Targeted to extreme poor; cash transfer; public works, and productive inclusion
Kenya Youth Employment and Opportunities Project	Targeted to middle of distribution; formal and informal apprenticeships; microentrepreneurship support
Liberia REALISE Project	Targeted to extreme poor; public works; support to microenterprises
Mongolia Employment Support Project	Targeted to middle of distribution; intermediation; active labor market programs; labor market information

Source: Ahmed, Cunningham, and Santos (2022)

This framework builds off the framework presented in Guven et al. (2021) which delineates a continuum of services across the income distribution. Households at the bottom of the distribution are poor households, and are already operate at subsistence levels of consumption, thus generally require consumption support. Moving up the income distribution, non-poor but still low-income households in the informal sector may need other services such as social insurance, or other productivity enhancing measures, like microfinance. These households may not be poor enough to need immediate consumption support, but they tend to be vulnerable to shocks, are at-risk of poverty, tend to liquidity constrained, and typically have limited precautionary savings. At the other right-tail of the income distribution would be the richer and better educated households where services like commercial finance, formal tertiary education, or formal skills development may be appropriate services.

Finally, formalization as a standalone objective should not necessarily be a focus, but informal sector entities (individuals, households, or enterprises) may, however, still achieve some degree of visibility in government systems – and thus become formal in some senses. Policy discussions around informality can be broad, and include objectives that may be secondary to a social protection agenda. For example, policy makers may be primarily motivated by informality as a policy issue for the purposes of improving revenue collection through increased legislation or enforcement actions. While this may be a valid policy objective, it may not necessarily be most relevant for a social protection and jobs agenda, aside from the fact that there is a substantial literature that suggests that formalization policies have generally not had their desired impacts on formalization rates. Returning to the drivers of informality summarized in Figure 5, government action with a formalization action may be focused on entities who choose to be informal as a revenue

maximization strategy.⁶ However, by increasing coverage of different social programs, be their safety nets, active labor market programs, or financial programs, inter alia, informal sector entities may still become visible, as they enter administrative databases and systems.

⁶ Kanbur (2017) identifies actors in dual economies (drawing heavily on evidence from India), as being of four types based on their informality status, and their reasons for informality, based on legal compliance. They are entities that are within the ambit of the law and complying; entities that are within the ambit of the law but not complying; entities that adjust their activity to go/remain outside the ambit of the law; and entities that are always outside the ambit of the law. In this typology, all but the first group are informal, and the second and third groups are choosing to be informal.

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Annex 1: Data and methodology

This note uses the latest available Labor Force Survey (LFS) or Household Income and Expenditure Survey (HIES) from each country. Data was available for all South Asian countries except for Afghanistan. The analysis relies on employment and welfare modules from LFS and HIES surveys.¹ These are nationally representative surveys that cover between 18,000 to 120,000 households in each country depending on its size and population. Though each survey covers a variety of topics, this note focused on demographics, education, current and past economic activities, current noneconomic activities, unemployment, and underemployment.

Mincer's (1974) human capital earnings function, often known as the "Mincerian Model," has been used to estimate the wage gap between the formal and informal sectors, as well as the impact of education on wage return. We extend the model by including a number of variables. The following standard form of semi-log earnings function is used separately for each country to estimate the formal/informal earnings gap:

$$\ln(Y_i) = \alpha + \beta(X_i) + \gamma(Z_i) + \epsilon_i$$

Where $\ln(Y_i)$ is the log of monthly earnings or wages for individual i , X_i is a vector denotes the set of individual, household and job characteristics of individual i . The different covariates include hours worked per week, sector of employment, professional job holder or not, training status in last 12 months, age, age-squared, education, and household wealth status. In the LFS datasets, there was no direct variable that recorded the labor market experience of individuals. Therefore, age was used as a proxy for labor market experience.

This note also analyses the determinants of informal employment choice for Bangladesh and Nepal. A Probit regression model (Green, 2008) is employed in estimating factors that influence the choice of type of employment (formal versus informal). The dependent variable was the choice of informality, which was equal to one if the individual works at informal job sector, and equal to zero otherwise. The independent variables included hours worked per week, sector of employment, professional job holder or not, training status in last 12 months, age, age-squared, gender, education, household wealth status, and two interaction term 1) between education and wealth status to see if there is any effect of education level on the choosing informal job sector differs according to wealth status and 2) interaction term between wealth status and training status. The Probit model has the following form:

$$\Pr(Y = 1 | X_1, X_2, \dots, X_k) = \Phi(\beta_0 + \beta_1 X_1 + \beta_2 X_2 + \dots + \beta_k X_k)$$

where,

Y = binary dichotomous dependent variable

X = regressors or independent variables

Φ = cumulative standard normal distribution function

Annex 2: Country-Level Standardized Probit Regressions, estimating the probability of being a wage informal or unpaid family worker

	Bangladesh	Bhutan	Nepal
VARIABLES	Wage Informal+ Unpaid Family Worker=1 vs Wage formal=0	Wage Informal+ Unpaid Family Worker=1 vs Wage formal=0	Wage Informal+ Unpaid Family Worker=1 vs Wage formal=0
Education (Base: No education)			
Primary	-0.038***	0.006	-0.011
	(0.003)	(0.010)	(0.010)
Secondary	-0.085***	-0.006	-0.075***
	(0.003)	(0.009)	(0.008)
Post-secondary	-0.132***	-0.029***	-0.103***
	(0.002)	(0.006)	(0.005)
Sector of Employment (Base: Agriculture)			
Industry	-0.087***	-0.134***	-0.045***
	(0.002)	(0.010)	(0.010)
Service	-0.102***	-0.253***	-0.119***
	(0.002)	(0.013)	(0.010)
Monthly wage			
Hours worked per week	-0.025***	0.031***	-0.015***
	(0.002)	(0.007)	(0.005)
Training in last 12 months	0.027**	-0.052***	0.003
	(0.013)	(0.017)	(0.013)
Interaction terms (Training*Sector)			
Industry* Training	-0.016***	0.014*	-0.004
	(0.005)	(0.008)	(0.012)
Service* Training	-0.042***	0.014	-0.013
	(0.012)	(0.019)	(0.013)
Age	-0.193***	-0.276***	-0.435***
	(0.013)	(0.071)	(0.043)
Age-Squared	0.127***	0.242***	0.301***
	(0.011)	(0.065)	(0.040)

	Bangladesh	Bhutan	Nepal
VARIABLES	Wage Informal+ Unpaid Family Worker=1 vs Wage formal=0	Wage Informal+ Unpaid Family Worker=1 vs Wage formal=0	Wage Informal+ Unpaid Family Worker=1 vs Wage formal=0
Female	-0.039***	0.025***	0.002
	(0.002)	(0.006)	(0.005)
Urban	0.013***	-0.002	-0.001
	(0.002)	(0.006)	(0.005)
Wealth quintile Dummy (B40=1, Q3+Q4+Q5=0)			
Respondent is in Bottom 40	0.022***	-0.007	0.030**
	(0.004)	(0.011)	(0.013)
Interaction term (Education* Bottom 40) Base: No Education* Bottom 40			
Primary* Bottom 40	-0.001	-0.016	-0.012
	(0.003)	(0.010)	(0.012)
Secondary * Bottom 40	0.001	-0.010	-0.030***
	(0.003)	(0.008)	(0.010)
Post secondary * Bottom 40	0.008***	-0.000	-0.017***
	(0.001)	(0.005)	(0.004)
Observations	88,179	5,675	11,412

Source: Own calculations, based on LFS for Bangladesh (2016-17), Bhutan (2016) and Nepal (2018).
Note: Standard errors in parentheses; *** p<0.01, ** p<0.05, * p<0.1